Capital Stock and Ownership

This Section of the Handbook presents information concerning the following:

- Mutual organization.
- Mutual holding companies.
- Stock organization.

LINKS

Program

Appendix A

- Types of capital stock.
- Conversions from mutual to stock organization.
- Securities and Exchange Commission (SEC) reporting requirements for publicly traded companies.
- Insider stock trading.
- Change in control.
- Divestiture of control.
- Contributed capital.
- Savings and loan holding companies.
- Capital distributions.
- Loans by savings associations on its own stock.
- Employee stock ownership plans (ESOPs).

MUTUAL ORGANIZATION

Savings associations organized as mutual institutions issue no capital stock and therefore have no stockholders. Mutual savings associations build capital almost exclusively through retained earnings. Mutual savings associations may receive pledged deposits and issue mutual capital certificates and subordinated debentures, however, mutuals rarely use these capital forms. When a new mutual savings association organizes, certain founding members pledge savings for the time required for the new mutual to build-up capital and operate profitably.

Background

The first savings associations appeared in the United States in the first half of the nineteenth century. Savings banks first appeared in Boston and Philadelphia in 1816. The first savings association was in 1831 in Frankford, Pennsylvania, now part of the city of Philadelphia. All thrift type institutions were originally mutual institutions. All federal savings associations were in mutual form from 1933 until 1974, when Congress amended the Home Owners' Loan Act (HOLA) to permit the conversion of federal mutual savings associations to stock form. The Garn-St. Germain Depository Institutions Act of 1982 first authorized the direct chartering of federal stock savings associations.

Mutual savings associations initially were organized by individuals and groups for the common good of working class individuals and families who lacked the financial service facilities necessary for the accumulation of capital through savings plans and access to credit for housing needs. These mutual associations greatly expanded in number and location throughout the nineteenth and early twentieth centuries. They generally were small associations, although some eventually grew to substantial size, mostly in the larger cities. Although a substantial number of mutual associations migrated to stock form savings associations through conversion since the mid-1970s, there remain a substantial core of mutual associations. As of September 2003, there were over 300 mutual savings associations under OTS supervision and several hundred more state chartered savings banks under FDIC supervision. These mutual savings associations, while generally smaller than the stock associations, carry on the basic mission of the founders of the thrift movement. The mutual savings associations remain close to their communities and the immediate needs of their localities for basic banking services for the citizens. In general, mutual savings associations often tend to have higher capital levels, somewhat lower earnings, and high quality assets.

Ownership of Mutual Savings Associations

The concept of ownership in mutual savings associations resulted in extensive discussion and subsequent litigation. The courts have determined that mutual account holders have only a contingent interest in the surplus of mutual savings associations in the event of liquidation. In the first case to challenge the newly adopted conversion regulations of the Federal Home Loan Bank Board, York v. Federal Home Loan Bank Board, the court concluded that conversion to a federal stock organization did not deprive the mutual depositors of property rights.

Members Rights of a Federal Mutual Savings Association

The federal mutual charter grants certain rights to mutual members, which give them some control over the affairs of the savings association. All holders of the savings association's savings, demand, and other authorized accounts are members of the savings association. The ability to exercise control over a mutual savings association by its members, however, is not coextensive with the rights of stockholders of ordinary corporations, although there are similarities. The members of a federal mutual savings association have the right to:

- Vote.
- Amend the charter.
- Amend the bylaws.
- Nominate and elect directors.
- Remove directors for cause.
- Request special meetings.
- Communicate with other members.
- Inspect the corporate books and records.
- Share pro rata in the assets of the savings association following liquidation.

In enacting the Home Owners' Loan Act (HOLA) Congress generally left to the OTS (or its predecessor, the FHLBB) the authority to determine when a mutual savings association's members have voting rights. Except for provisions relating to the conversion of a federal mutual to stock form, there is no statutory requirement that federal mutual savings associations' members have voting rights. Although the charter of a federal mutual savings association does grant such rights, it does not specify a member vote for all significant corporate transactions.

In practice, members delegate voting rights and the operation of federal mutual savings associations through the granting of proxies typically given to the board of directors (trustees) or a committee appointed by a majority of the board.

Mutual Holding Companies

In 1987, Congress authorized mutual savings associations and savings banks to reorganize themselves in a holding company structure, in which the holding company is owned by the mutual members. The purpose of this new structure was to afford all FSLIC or FDIC-insured mutual thrifts the opportunity to raise capital in an amount less than that required in a full mutual-to-stock conversion, while retaining the mutual ownership base. A mutual holding company reorganization permits an institution to raise incremental amounts of capital, provided that the mutual holding company retains a majority interest in the subsidiary savings association.

The Mutual Holding Company regulation implements § 10(o) of HOLA. Part 575 authorizes a mutual holding company to engage in capital raising activities. A mutual holding company's subsidiary savings association may issue up to 49.9 percent of its stock to persons other than the mutual holding company.

Alternatively, a mutual holding company (MHC) may create a new subsidiary stock holding company (SHC) that would exist between the MHC and its savings association in a three-tier corporate structure. The SHC, like a stock savings association subsidiary, must issue at least a majority of its shares to the MHC and could issue up to 49.9 percent of its shares to the public. The SHC must own 100 percent of the shares of the savings association subsidiary.

On August 9, 2002, OTS issued a Final Rule based on the Gramm-Leach-Bliley Act. OTS changed the activities limitations for MHC's to mirror those applicable to financial holding companies. These changes enhance the MHC structure as an alternative to full conversion for mutual savings associations.

Stock Organization

Section 552.2-1 outlines the process for organizing a federal stock savings association. Stock organization means that management decisions are subject to shareholder vote and scrutiny. Stock savings associations must hold annual meetings of shareholders subject to regulatory requirements. These requirements appear in § 552.6 or applicable state law and/or § 14 of the Securities Exchange Act of 1934 (Exchange Act). Savings associations that convert to stock form face shareholder scrutiny and increased public disclosure requirements if they become a public reporting company under that act.

Capital Stock

Capital stock consists of stock certificates issued to investors (stockholders) as evidence of their ownership interest in the savings association. One or more individuals or any business entity such as a partnership, a trust, or a corporation may own the stock.

Common Stock

Common stock represents all the basic rights of ownership. Common stockholders exercise their basic rights in proportion to the shares owned. These rights include the following:

- The right to vote for the directors.
- The right to share in dividends declared by the board of directors.
- The right to share in the distribution of cash or other assets, after payment of creditors, in the event of liquidation of the savings association.

Savings associations may value capital stock on their books at a stated par value. A savings association will assign a nominal par value if the stock does not have a par value. Savings associations account for amounts paid in excess of the par value as additional paid-in capital.

The market value of shares does not coincide with par values. The market price reflects many factors, including the following:

- Overall economic conditions.
- Financial health of the savings association.
- Liquidity of the stock.
- Competition.
- Dividend policies.
- Growth potential.
- Market saturation in financial institution issues (supply and demand).

A savings association may list its shares on an organized exchange, or trade them over the counter (OTC). A savings association may act as its own registrar and transfer agent. If the savings association has 500 or more stockholders, the savings association must adhere to the SEC regulations when performing transfer agent functions.

Among the records a stock savings association must maintain is a (registrar's) list of stockholders. The list should include the following information:

- Name of holder.
- Address.
- Number of shares owned.
- Date acquired.
- Certificate number(s) held.
- Amount and type of dividend paid each stockholder.

It is important to promptly record transfers of shares to new owners. Savings associations, periodically, should reconcile the stockholder ledger with the general ledger control account and the stock certificate book.

Preferred Stock

Preferred stock carries certain preferences, such as a prior claim on dividends, over common stock. Often preferred stock conveys no voting rights, or only limited voting rights, to the holders. The articles of incorporation (charter) govern special rights of a preferred stock issue. The chartering authority may also regulate stockholders' rights.

Whether preferred stock is includable in regulatory or generally accepted accounting principles (GAAP) capital depends on its permanence as a funding source. The status of preferred stock as part of capital also depends on whether redemption of the stock is required to occur only upon the liquidation or termination of the savings association. Like common stockholders, preferred stockholders have basic ownership rights and do not have priority over creditors in the event of liquidation.

Although forms of permanent perpetual preferred stock exist, other preferred stock contains defined redemption terms and consequently it is not as permanent or long term a funding source as common stock.

Savings associations not subject to federal securities laws financial reporting requirements may make financial reports using Thrift Financial Report (TFR) instructions and rely on OTS capital regulations. Under 12 CFR Part 567 (Capital), savings associations include noncumulative perpetual preferred stock in core capital (§567.5(a)(1)(ii)). Savings associations include cumulative perpetual preferred stock in supplemental capital (§567.5(b)(1)(i)). Supplemental capital also may include certain redeemable preferred stock and subordinated debt issued under OTS regulations and memoranda. Eligibility for such instruments to qualify as part of regulatory capital depends on the timing of the redemption and other contractual characteristics. See 12 CFR § 563.81, Issuance of subordinated debt securities and mandatorily redeemable preferred stock.

Subchapter S Corporations

Subchapter S Corporations generally receive pass-through tax treatment for federal income tax purposes. The Small Business Job Protection Act of 1996 made changes to the Internal Revenue Code that allows financial institutions, and their parent holding companies, to elect Subchapter S Corporation status under the Code. The savings association must meet the following criteria:

- Shareholders may only be individuals, certain estates, and trusts.
- There may be no more than 75 shareholders and they must all consent to the election of S Corporation status.
- There must be only one class of stock.
- The savings association must use (or convert to) the specific charge-off method in accounting for bad debts for tax purposes.
- The savings association must use a calendar year, unless IRS grants permission to use some other year.

A Subchapter S holding company may wholly (but not partially) own a savings association that is a Subchapter S Corporation. Thus, holding companies and their wholly owned depository institution subsidiaries are both eligible for S Corporation status.

Savings associations may voluntarily or involuntarily lose their S Corporation status. Although there is no penalty or direct tax for a termination, either a voluntary or an involuntary loss may have adverse effects on a savings association's capital. For example, revocations may adversely affect an association, because the association may need to re-establish deferred tax accounts, which may reduce capital.

Ability to Raise Capital

If an S Corporation needs to raise capital, its initial efforts will often focus on selling additional common stock to its existing stockholders to preserve its tax status. If existing stockholders are unable or unwilling to properly capitalize the savings association, the association will normally offer to sell common stock to Subchapter S eligible investors who consent to the tax election. The association should seek to limit the increase in the number of its stockholders to stay within the 75-shareholder limit for S Corporation.

S Corporation stockholders customarily sign shareholder agreements that prevent them from selling stock or otherwise transferring their stock to ineligible stockholders. These agreements typically require a shareholder who wishes to sell stock to first offer the shares to the other existing stockholders before offering the shares to any other party. As a prerequisite to purchasing an S Corporation's stock, a new investor must agree to sign the shareholder agreement.

If the association cannot successfully increase its capital through these means, it may pursue other potential investors who may cause the association to lose its Subchapter S election. Alternatively, the association may have to issue a second class of stock that will result in an involuntary termination of its election. In either case, the association would not incur any tax penalties because of its return to C Corporation status. Therefore, an association's tax status as an S Corporation does not prevent it from raising additional capital.

STOCK CONVERSION

For mutual savings associations, conversion to stock form is another avenue available to raise capital in the equity market.

To facilitate the conversion process, management may contract for the services of attorneys, accountants, appraisers, and conversion managers who have conversion experience. Savings associations record conversion sales proceeds after deduction of conversion expenses. In smaller offerings, conversion expenses may amount to over ten percent of the equity raised.

Following is a description of various types of conversions. See Part 563b for additional information.

Standard Conversion

A standard conversion offers a funding source for savings associations. In this form, eligible account holders receive nontransferable, pro-rated subscription rights to purchase the stock of the converting savings association before the public offering. Savings associations sell shares of the converting institution not purchased by persons with subscription rights either in a public offering through an underwriter or by the savings association in a direct community offering.

Submission of a conversion plan according to Part 563b, Subpart A, is the first requirement before effecting a standard conversion. The resulting savings association must comply with the capital standards of Part 567. The accounting used for acquiring assets and liabilities in a standard conversion is generally historical cost of the acquired savings association (pooling-of-interest accounting).

Supervisory Conversion

A supervisory conversion permits savings associations that fail to meet specified capital levels to raise additional capital without government assistance. The resulting savings association must be a viable entity under Part 563b, Subpart B.

Any significantly undercapitalized SAIF-insured savings association will qualify for a supervisory conversion unless OTS determines otherwise. OTS may permit, on a case-by-case basis, an undercapitalized savings association to undertake a supervisory conversion if the savings association can demonstrate that a standard conversion is not feasible.

A savings association may accomplish a supervisory conversion through a public or nonpublic offering (that is, the sale of the savings association's securities issued in the conversion directly to a person or persons) or merger/conversion.

A majority of the board of directors of the converting savings association must adopt a plan of supervisory conversion that is in accordance with Part 563b. The members of the savings association shall have no rights of approval or participation in the conversion or rights to the continuance of any legal or beneficial ownership interest in the converted savings association.

Merger Conversion

A merger conversion occurs when an existing stock institution or holding company acquires a converting mutual savings association. The converting mutual exchanges its stock for stock of the acquiror. OTS limits merger conversions to cases involving financially weak savings associations. OTS will also consider requests for waivers from this general policy for very small institutions, such as those with assets under $25 million, for whom a standard conversion is not a viable option.

Review of Exchange Act and Securities Offering Filings

Under §12(i) of the Exchange Act, OTS has the powers, functions, and duties vested in the SEC to administer and enforce several sections of the Exchange Act for savings associations. The applicable sections are §§ 12, 13, 14(a), 14(c), 14(d), 14(f), and 16 of the Exchange Act and §§ 302, 303, 304, 306, 401(b), 404, 406, and 407 of the Sarbanes-Oxley Act. OTS is the securities regulator for all HOLA federal charters (both SAIF and BIF members that have registered securities with OTS). In addition, OTS is the securities regulator for state chartered savings associations that have registered securities with OTS. The FDIC is the comparable regulator for all BIF-insured, state chartered savings banks. The securities of savings and loan associations are exempt from registration under § 3(a)(5) of the Securities Act of 1933. OTS has promulgated 12 CFR Part 563g to require federal savings associations to register issuances of securities that are not otherwise exempt from registration.

A savings association may become subject to reporting obligations under the Exchange Act in one of three ways:

- Section 12(b) of the Exchange Act requires the registration of any class of a savings association's securities registered on a national securities exchange.
- Exchange Act rules generally require that each savings association with 500 or more shareholders and $5 million or more in assets register its equity securities under the Exchange Act. Savings associations may satisfy this requirement by filing Form 10 with OTS. Also, savings associations may voluntarily register securities not otherwise requiring registration by filing Form 10 with OTS.
- Section 563b.530(a) generally requires savings associations converting from the mutual to the stock form to register the class of securities issued in the conversion under the Exchange Act. Savings associations may not deregister such securities for three years.

Each savings association, not otherwise required to report under the Exchange Act, has special responsibilities relating to filing of offering circulars with the Business Transactions Division (BTD). Section 563g.2 provides that no savings association may offer or sell any security unless the offer or sale includes an effective offering circular. Part 563g provides for the declaration of effectiveness of such offering circulars. If BTD declares an offering circular effective pursuant to Part 563g, savings associations must make filings pursuant to § 563g.18 with OTS. Savings associations must make these filings for at least the first year during which the offering circular becomes effective. These filings consist of periodic and current reports on Forms 10-K, 10-Q, 10-KSB, 10-QSB, and 8-K, as § 13 of the Exchange Act may require. The duty to file reports under § 563g.18 is automatically suspended for any fiscal year under the following condition:

- If at the beginning of the fiscal year, (other than the fiscal year the offering circular became effective) the securities of each class to which the offering circular relates are held of record by less than 300 persons.

In certain circumstances, an exemption from the filing requirements is available. Savings associations must file offering circulars required under Part 563g with both BTD and the appropriate regional office.

Currently, only a limited number of savings associations have a class of securities registered under the Exchange Act. They are subject to Exchange Act current and periodic reporting requirements and rules governing a wide range of activities. Such activities include proxy solicitations, tender offers, and the acquisition of securities by officers, directors, and significant shareholders.

BTD and the Accounting Policy Division (APD) review Exchange Act and securities offering filings of savings associations for compliance with the Exchange Act and OTS regulations. The applicable OTS regulations are 12 CFR Parts 563b, 563c, 563d, and 563g.

The regional offices are responsible for timely review of filings of savings associations and holding companies for information of supervisory concern. Regional staff should alert BTD or APD to disclosure problems noted during these reviews. For a more detailed discussion of the Washington and Regional Processing of Exchange Act Filings, refer to Appendix A.

Description of Filings

The Annual Report (Form 10-K or Form 10-KSB)

Savings associations must file this report after the close of a fiscal year.

The Quarterly Report (Form 10-Q or Form 10- QSB)

Savings associations must file this report for each fiscal quarter (except the fourth quarter).

Forms 10-KSB and 10-QSB are public filings filed by a small business under SEC Regulation S-B. Under Regulation S-B, a small business filer is generally defined as a company that meets all of the following criteria:

- It has revenues of less than $25,000,000.
- It is a U.S. or Canadian filer.
- The entity is not an investment company.
- The parent corporation is also a small business filer if the entity is a majority owned subsidiary.

A company is not a small business filer if it has a public float (the aggregate market value of the filers outstanding securities held by the non affiliates) of $25,000,000 or more.

The Annual and Quarterly Reports provide specific financial information regarding the savings association as well as management's discussion of the savings association's financial condition. The reports also include a description of matters voted on by securities holders, and other relevant matters as required by the applicable form and regulations.

The Annual Report is due 90 days after the savings association's fiscal year end, and the Quarterly Report is due 45 days after the fiscal quarter end. If a savings association qualifies as an accelerated filer, the Annual and Quarterly Reports are due on an accelerated basis. As defined by the SEC, an accelerated filer is a domestic reporting company that has a common equity public float of at least $75 million that meets the following conditions:

- It has been subject to the Exchange Act's reporting requirements for at least 12 calendar months.
- It previously filed at least one annual report.
- The entity is not eligible to use forms 10-KSB and 10-QSB.

The following chart sets forth the transition filing deadlines for the Annual and Quarterly Reports:

For fiscal years ending on or after	Form 10-K deadline after fiscal year end	Form 10-Q deadline after fiscal quarter end
December 15, 2002	90	45
December 15, 2003	75	45
December 15, 2004	60	40
December 15, 2005	60	35

The Current Report (Form 8-K)

Savings associations must file this report with OTS when one of the following events occurs and within the following time frames:

- Any changes in control of the savings association - 15 days.
- Acquisition or disposition of assets (of a significant amount other than in the ordinary course of business) - 15 days.
- Placing of the savings association in receivership or conservatorship - 15 days.
- Any change in the savings association's certifying accountant - 5 days.
- Occurrence of other events the savings association deems to be materially important to security holders - no time frame, but within a reasonable time.
- Resignation of directors - 5 days.
- A change in fiscal year - 15 days.

Beneficial Ownership Reports

The Initial Statement of Beneficial Ownership (Form 3)

Persons who fall into any of the categories listed below must file a Form 3 with OTS within ten days after achieving such status.

- Officers (regardless of whether they own any securities).
- Directors (regardless of whether they own any securities).
- Beneficial owners of ten percent or more of any class of the savings association's equity securities.

A Statement of Change in Beneficial Ownership of Equity Securities (Form 4)

Previous filers of Form 3 must file Form 4 when a change occurs in the nature or amount of the person's beneficial ownership of the savings association's equity securities. Filers must file Form 4 within ten days after the end of the month in which a change occurs.

Annual Statement of Changes in Beneficial Ownership (Form 5)

Report annually, within 45 days of the end of the fiscal year, any other small changes in ownership.

Reports of Beneficial Ownership (Schedule 13D and Schedule 13G)

Shareholders must file Schedule 13D within ten days of the acquisition of beneficial ownership of more than five percent of any class of equity securities. Any material change in the facts of the statement requires that the shareholder promptly (generally within two business days of the material change) file an amendment.

Mutual funds and other institutions that invest funds or manage portfolios for beneficial owners must file Schedule 13G. Filers must file Schedule 13G within 45 days after the end of the calendar year.

Shareholders must file 13D and 13G reports with the savings association, OTS, each exchange where the savings association's securities trade, or to the National Association of Securities Dealers, Inc. (NASD) if the National Association of Securities Dealers Automated Quotation System (NASDAQ) quotes the stock.

In reviewing Forms 3, 4, and 5 and Schedules 13D and 13G, BTD attorneys watch for issues related to Part 574, the potential for hostile takeovers, and possible trading on insider information. You should be alert to these possibilities and alert appropriate OTS staff to relevant information.

Other Types of Beneficial Ownership

Persons may own directly any stock held in their own name, or the stock may be held by a bank, broker, or nominee in "street name" for their account. Under the convention of holding shares in street name, a broker executes the trade and holds the stock in the name of the brokerage firm or a nominee. The savings association, through the shareholder (registrar's) ledger, is unaware of the individual initiating the transaction. There are no rules governing the disclosure of ownership held in street name except for the threshold reporting requirements described above.

Persons are the beneficial owners of any stock that they have the right to acquire through the exercise of presently exercisable options, including options granted through a stock option plan. Indirect beneficial ownership includes stock held in the name of another person if, because of an agreement or relationship, a person obtains benefits substantially equivalent to those of ownership. Such benefits include the right to receive income and the right to control transfer of the stock. For example, a person generally is the beneficial owner of stock in the following situations:

- Stock held by certain family members, such as a spouse or minor children.
- Stock owned as trustee, where the person or members of the person's immediate family have a vested interest in the income or principal of the trust.
- Stock held in trust for which the person is a beneficiary.
- Stock owned by a partnership of which the person is a member.
- Stock owned by a corporation that the person controls.

Proxy and Information Statements

Exchange Act Regulations 14A and 14C require the filing of preliminary copies of all proxy statements, other soliciting materials, and Information Statements. Savings associations must file this material with OTS at least ten calendar days prior to the date of first sending or giving such information to shareholders unless the materials relate to the merger or acquisition of the savings association. Savings associations must file definitive copies of the above materials with OTS no later than the date of sending or giving such information to shareholders.

In certain circumstances, savings associations must provide an Information Statement that contains the information specified by Regulation 14C under the Exchange Act. In those instances where a savings association plans corporate action, the Exchange Act requires the filing of an Information Statement. The Information Statement may relate to an annual meeting, a special meeting instead of an annual meeting, or a written consent instead of either an annual or special meeting that includes election of directors. This is a requirement even where there is no solicitation of proxies. The corporate action may occur either at a meeting of the savings association's security holders or by written authorization or consent of such holders.

Annual Report to Shareholders

Savings associations must mail to shareholders copies of the Annual Report to Shareholders. Savings associations mail the Annual Report to Shareholders with, or subsequent to the mailing of, either proxy solicitation material or an Information Statement.

INSIDER STOCK TRADING

There are substantive limitations on the ability of savings association directors, officers, and ten percent shareholders to trade in the savings association's stock. Generally, any profit realized from any purchase and sale or sale and purchase of the savings association's stock within a six-month period (short swing trade) is subject to recapture. Either the savings association or the savings association's stockholders by filing suit on its behalf (15 USC § 16(b)) may seek recapture. The rule provides a rigorous guard against misuse of confidential information by insiders.

Furthermore, the Exchange Act generally prohibits directors, officers, and ten percent stockholders from making any short sale of their savings association's stock. That is, any sale of stock that the seller does not then own. The Exchange Act also requires that directors, officers, and 10 percent stockholders deliver to buyers within 20 days any stock they sell. Alternatively, the Exchange Act requires the depositing in the mail within 5 days any stock sold by directors, officers, and 10 percent stockholders.

In addition, Rule 10b-5 under the Exchange Act (17 CFR § 240.10b-5) prohibits a person from trading any stock using material inside information. Inside information refers to material information not available to the public in general. The rule also prohibits a person in possession of material nonpublic information from selectively disclosing this information to others (tipping) and generally bars the tippees (persons who may have received such nonpublic information) from trading on such a tip. Information is material for this purpose if a reasonable investor would consider it important in reaching an investment decision or would attach actual significance to the information in making the decision. Thus, savings association officers, directors, and others in possession of material inside information must not trade in the savings association's stock until the information is available to the investing public. Managers must not make any disclosures of material information to selected persons without concurrently releasing the information to the public.

CHANGE IN CONTROL

Regulators have concerns about the control of a savings association's voting rights because a change in control may influence the direction and operating policies of the savings association. No person may acquire control of a savings association through a purchase, assignment, transfer, pledge, or other disposition of voting rights of such savings association without OTS approval. This includes the individual acting directly or indirectly, or through or in concert with one or more other persons.

Companies that seek to acquire direct or indirect control of a savings association must also seek OTS approval pursuant to § 10(e) of the HOLA before the acquisition of control. Companies may act in concert with individuals or other companies to acquire control of a savings association. OTS rules on acquisition of control of savings associations are in 12 CFR Part 574. See Applications Handbook Section 310, Change of Control and Section 320, Rebuttals of Control for a more detailed discussion of changes of control, rebuttals of control, and acting in concert.

Section 563.181 contains special notification requirements that apply whenever a change occurs in the outstanding voting rights that will result in control (or a change in control) of any mutual savings association. The president or other chief executive officer must report such facts to the OTS. They should file the report within 15 days of their knowledge of such change.

Section 563.183 requires the savings association to file a report whenever there is a change in control of any savings association or holding company and there is also a change or replacement of the chief executive officer within a specified time.

The president or other chief executive officer must file a report when a change in control of a savings association or holding company occurs concurrently with, or within 60 days after or 12 months before, a change or replacement of the chief executive officer. (A change in control also mandates filing Form 8-K for a savings association or holding company subject to public reporting requirements of the Exchange Act.)

The president or other chief executive officer must report to OTS whether a change in ownership or other change in the outstanding voting rights under §§ 563.181 or 563.183 will result in control or a change in control of the savings association or holding company. Section 574.4 outlines the conditions under which an acquirer possesses control. The regulation also includes conclusive control determinations.

Section 563.181(c) states the conditions that will require a report from a mutual savings association president or CEO when there is a solicitation of voting rights of the savings association. If a solicitation is of a continuing nature, it is necessary to file a report only when the solicitation begins. The report should indicate the continuing nature of the solicitation. No further reporting is necessary unless or until there is a change in the solicitor.

The president or CEO of the savings association or the holding company should file the report required under 12 CFR §§ 563.181 and 563.183. Under 12 CFR § 516.1(c), they should send an original and two copies to the regional office.

Savings associations must provide a business plan with each of the following applications:

- Approval of change in control of a stock savings association.
- Change in control of a mutual savings association.
- Change in or replacement of the chief executive officer.

Willful violations of §§ 563.181 and 563.183 may be subject to harsh enforcement action, including civil money penalties. If you discover such activity, you should remind savings associations and savings and loan holding companies of these reporting requirements. Savings associations and savings and loan holding companies are to resolve any doubt regarding the necessity of filing by submission of a report.

REGULATORY CONSIDERATIONS

Divestiture of Control

Section 567.13 requires that any acquiror subject to a capital maintenance obligation must give prior written notice to OTS if the acquiror proposes a divestiture of the savings association.

After receiving the notice, OTS has 90 days to conduct an examination of the savings association. OTS determines the extent of any capital deficiency and communicates the results to the acquiror. If the examination indicates that no deficiency exists, the acquiror may divest control of the savings association upon receiving written notice of the examination results.

If a capital deficiency does exist, any acquiror subject to a capital maintenance agreement may only divest a savings association if they provide OTS with a capital infusion agreement. Such an agreement must provide that the acquiror will infuse the savings association with the amount necessary to remedy the deficiency. Further, the acquiror must arrange for payment, satisfactory to OTS, or otherwise satisfy the deficiency. If the acquiror provides OTS with a satisfactory agreement before the completion of an examination made to determine the extent of any capital deficiency, it may proceed to divest control. Also, the acquiror must arrange for payment, satisfactory to OTS, to ensure payment of any deficiency. Alternatively, the acquiror may immediately satisfy the deficiency.

Contributed Capital

Savings associations may accept without limit the following capital contributions:

- Cash.
- Cash equivalents.
- Other high quality, marketable assets provided they are otherwise permissible for the savings association.

Savings associations may accept other forms of contributed capital if the association receives prior OTS Regional Director approval. In considering whether to approve a contribution of capital, the Regional Director will consider the following criteria:

- The assets are separable and capable of being sold apart from the savings association or from the bulk of the savings association's assets.

- The savings association has established an independent market value of the assets and demonstrated that such assets are likely to hold their market value in the future or that the association has established a process for periodic, independent revaluation of the assets.

- The savings association has demonstrated that a market exists for the assets.

- The transaction is in compliance with the requirements of 12 CFR § 563.41.

- The financial condition and adequacy of capital of the savings association.

Generally, the Regional Director will not approve noncash capital contributions that do not meet the above criteria or that constitute more than 25 percent of capital prior to the proposed conversion, unless good cause is demonstrated.

Noncash capital contributions in connection with permission to organize applications or applications under 12 CFR Part 559 will be evaluated pursuant to the criteria established for those application reviews.

Savings and Loan Holding Companies

OTS regulation, 12 CFR § 584.1, requires savings and loan holding companies to file Form H-(b)11 with the appropriate regional office.

Holding companies with securities registered with the SEC under the Exchange Act must attach certain SEC filings to the H-(b)11. For example, the H-(b)11 must include the following information:

- Proxy material filed with the SEC.

- The annual report on Form 10-K.

- Current reports filed on Form 8-K.

- Any prospectus filed in connection with the public offering of securities.

- SEC reports not excluded by request of the OTS regional office.

Capital Distributions

A savings association is permitted to make a distribution of cash or other property subject to 12 CFR § 563.140. Whether a savings association must file a notice or application with OTS depends on whether the capital distribution falls within certain criteria. Section 12 CFR 563, Subpart E - Capital Distributions provides guidance on capital distributions by a savings association. Federal Deposit Insurance Corporation Improvement Act (FDICIA) § 38 prohibits an insured institution from taking certain actions if, as a result, the institution would fall within any of the three undercapitalized capital categories. The prohibited actions include the following:

- Declare any dividends.
- Make any other capital distribution.
- Pay a management fee to a controlling person.

See 12 CFR § 565.4(b) and Examination Handbook Section 120, Capital Adequacy, for guidance regarding the capital categories.

A savings association permitted to make a capital distribution under the prompt corrective action regulations may do so in accordance with 12 CFR Part 563. The capital distribution regulation incorporates FDICIA's capital distribution requirements and imposes other limitations comparable to those applicable to national banks.

Subchapter S Distributions

Distributions by a Subchapter S Corporation are dividends for regulatory purposes, including prompt corrective action. This includes distributions intended to cover a shareholder's personal tax liability for the shareholder's proportionate share of the taxable income of the institution.

OTS may restrict such distributions to shareholders in amount or prohibit them in some instances. There may be some cases where the amount of dividends that shareholders would need to receive to pay their personal income taxes would exceed the amount of dividends allowable under 12 CFR Part 563, Subpart E - Capital Distributions. It is also possible for an association to be generating taxable income in a period when the association is reporting a loss or nominal income for financial reporting purposes. This situation can arise, for example, when an association takes a large provision for loan losses because of credit quality problems but has not yet charged off specific loans.

Loans by Savings Association on Its Own Stock

Pursuant to The Financial Regulatory Relief and Economic Efficiency Act of 2000 (FRREEA), OTS now prohibits savings associations from making loans or discounts on the security of the shares of their own capital stock. Since repayment of the loan may require the association to take title to the collateral and remarket it, OTS considers such action an unsafe and unsound practice, particularly for an association that cannot easily remarket its stock. Prior to FRREEA, OTS did not prohibit savings associations from making loans on its own stock.

The statute allows a savings association to make a loan or discount on the security of the shares of its own capital stock if it acquires the stock to prevent loss upon a debt previously contracted for in good faith. Savings associations may also take their own stock as additional collateral in "work-out" situations. This provides lenders with greater security against default and enhances the safe and sound operations of a lender. Savings associations may own or acquire shares to reduce capital.

EMPLOYEE STOCK OWNERSHIP PLANS

It is customary for a significant holder of a savings association's shares to be an Employee Stock Ownership Plan (ESOP). An ESOP is an employee benefit plan. The Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) of 1986 describe an ESOP as a stock bonus plan, or combination stock bonus and money purchase pension plan. ESOPs invest primarily in an employer's stock, generally by using tax deductible contributions made to the ESOP under the terms of the plan. Other pension plans normally limit the amount of the plan's assets allowable for investment in the employer's securities.

Federal legislation encourages the use of ESOPs to help achieve two major objectives:

- Broadening stock ownership of corporations by employees.
- Providing corporations with an additional source of capital funds.

A plan and trust are the vehicles used to establish an ESOP. The trustee is typically a financial institution. There are over 100 savings associations with trust powers. A savings association with trust powers can be the trustee for its own ESOP and the ESOPs of other employers.

After the establishment of the plan and the trust, the employer periodically contributes to the ESOP. The ESOP uses the contributions to purchase stock of the employer and to pay administrative and other expenses.

A common form of this type of benefit plan is the leveraged ESOP, whereby the sponsoring company forms a tax-qualified ESOP trust. The ESOP then borrows funds from a lending institution to acquire shares of the employer's stock. The stock may consist of outstanding shares, Treasury shares, or newly issued shares.

The debt of the ESOP is usually collateralized by the pledge of the stock to the lender. Also, there is either a guarantee or a commitment from the employer to make future contributions to the ESOP sufficient to cover the debt service requirements. There is a prohibition on the use of guarantees during a stock conversion. In leveraged ESOPs, the employer provides contributions to repay the debt and pay administrative expenses associated with the plan.

A suspense account under the control of the trustee of the plan usually holds the stock shares. Employees receive credit to their individual account when the trustee releases shares from the suspense account. The trustee releases shares from the suspense account as the ESOP repays the loan.

An ESOP must be tax qualified in order for the corporation's contribution to the plan to be tax free. This means the plan must meet certain requirements specified by the Internal Revenue Code and is, therefore, subject to IRS examination. These requirements pertain to participation, vesting, distribution, and other rules designed to protect the interests of the employees.

Recognition of a deferred tax liability may occur if a savings association contributes more than the maximum percentage allowed for deduction in the current year. This allows for an inter-period tax allocation in a future year. Further, ESOPs allow for an above the line deduction for federal income tax purposes. This consists of a pre-tax deduction for employer contributions to the ESOP. The deduction includes both the principal and interest on the loan. Alternatively, if the ESOP is not leveraged, a deduction is allowable for the contribution up to a certain maximum. The net effect of this transaction is a reduction in operating income for the tax year.

An ESOP also may be a non-tax-qualified plan; the corporation simply receives no tax benefits as a result. Attraction or retention of key, highly compensated individuals often involves the use of non-tax-qualified ESOPs.

An ESOP is subject to the provisions ERISA and is consequently subject to the rules and regulations promulgated by the Department of Labor.

ESOPs provide the following benefits:

- Employees can acquire stock ownership in their employer without having to invest their own funds.

- The employer can use the ESOP to generate additional capital with tax-deductible dollars.

- Shareholders of a closely held corporation may benefit from creation of a larger market for their stock.

Federal savings associations have the implied authority to establish ESOPs, as they have the authority to compensate their employees. State-chartered savings associations also appear to possess the implied authority to establish ESOPs. This question, however, is a matter of state law. This also holds true for holding companies.

A savings association must establish and operate an ESOP in a safe and sound manner. Savings associations establishing employee pension plans must satisfy certain requirements specified in § 563.47. Such requirements concern funding, amendments for cost of living increases, and termination. In addition, there are recordkeeping requirements for plans not subject to the recordkeeping and reporting requirements of ERISA and the Internal Revenue Code. The rule is applicable to ESOPs formed by service corporations as well.

A savings association, another financial institution with trust powers, or a service corporation may administer or act as a trustee for an ESOP. Some savings associations have service corporations that are separate trust companies; when this is the case, ESOPs are typically trusteed by those service corporations.

Regulatory Restrictions and Issues

Conversions

Creation and structuring of ESOPs frequently occurs during conversions. There are a number of reasons to establish an ESOP, for example, to reward employees or to serve as an anti-takeover device. Discussion of three issues of particular interest relating to ESOPs follows:

- An ESOP may purchase no more than ten percent of the stock offered in a conversion.

- Limitations exist in a conversion as to the amount of stock that an individual may purchase and as to the amount of stock that management as a group may purchase. An individual's stock purchase limitations do not include stock held in an ESOP. There is no aggregation of the individual and ESOP stock holdings. Stock held in an ESOP that is a management recognition or retention plan (MRP) is non-tax-qualified. You should include stock held in a non-tax-qualified ESOP when determining the overall limitation for management purchases of conversion stock.

- OTS continues to prohibit a savings association, during a conversion, from extending its own credit to finance the funding of any employee stock benefit plan. OTS also prohibits a converting savings association from guaranteeing the debt incurred by the ESOP when it borrows from another lending institution. The major objective of the conversion process is to raise new capital. To permit a savings association to extend financing or to guarantee debt of the ESOP would be inconsistent with that objective. OTS requires a savings association to service the debt of the ESOP and reserves the right to disapprove a plan that is unrealistic subject to the provisions of ERISA.

Transactions with Affiliates

Savings associations are subject to 12 CFR § 563.41, which incorporates the Federal Reserve Board's Regulation W (12 CFR Part 223). These rules restrict and prohibit certain transactions with affiliates. In many cases, ESOPs are affiliates because the trustees are also directors, partners, or trustees of the savings association or its holding company. In some cases, an ESOP is an affiliate because of other control. For example, the ESOP may own, control, or have the power to vote 25 percent of a class of voting securities of the holding company or savings association. If the ESOP is an affiliate, the savings association may not make a loan, guarantee, or other extension of credit to the ESOP. This is because the collateral requirements of § 563.41(c) would be difficult, if not impossible, to meet. The securities issued by an affiliate of the association are not acceptable as collateral for a loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of the affiliate.

Despite this limitation, the funding of most ESOPs does not raise concerns. Typically, most ESOPs receive funding by a loan or guarantee from the holding company, as opposed to the savings association itself. A loan by the holding company is not a covered transaction under the affiliate regulations. Refer to Handbook Section 380 for further details on Transactions with Affiliates.

Compliance with ERISA

ERISA imposes complex requirements upon savings associations acting as trustee or in other fiduciary capacities for ESOPs, and severe penalties can result from statutory violations. In addition, the savings association, as the employer or plan sponsor of its own employees' retirement plan, is a party in interest pursuant to ERISA. This is the case whether or not the savings association is the trustee. Almost without exception, all transactions involving the purchase or sale of an asset of the plan to or from the savings association, any affiliate, officer, or employee are subject to the provisions of ERISA. There are only certain narrowly defined exemptions. The plan sponsor or its administrative committee may be subject to reporting, disclosure, and plan design requirements. There are also a number of other responsibilities under ERISA if the savings association is acting as trustee or in a fiduciary or similar capacity.

Risk to Savings Association as Employer or When Acting as Trustee

Most of the responsibility for administration lies with the trustee, and there consequently is little risk to the savings association when it uses an outside trustee. However, the plan and trust establishing the ESOP stipulate the respective rights, duties, and obligations of the employer and trustee. For example, the trustee has a fiduciary responsible to protect the assets of the ESOP. When a board member acts as trustee, a conflict may occur. A board member may be privy to an event that will drastically affect the employers' stock price. The trustees' fiduciary responsibility to the ESOP requires an action to protect and preserve the assets of the trust; however, this same person (board member) is prohibited from trading the stock based on insider information. The employer may be subject to liability under ERISA if it violates any of its duties or obligations.

Acquisition of Control

No company may acquire control of a savings association or holding company without the prior written approval of OTS. An exception under 12 CFR § 563(c)(1)(vii) allows an ESOP to acquire up to twenty-five percent of a savings association's stock.

Valuation of Savings Association Stock

Shares of a publicly held savings association where fair market value is recognizable in an actively traded market generally do not raise problems. Difficulties may arise with closely held savings associations; the stock is not marketable and the ESOP creates but a limited market. IRS Ruling 59-60 outlines major principles of stock valuation; one of the principles requires the use of an independent appraiser.

Repurchase Liability

At separation or retirement, employees generally want cash for their shares of stock. The law requires an employer to redeem the shares if there is no readily available market for them. The issue of cash availability can become a critical one for a small, privately held savings association. The ESOP repurchase liability is the savings association's continuing obligation to repurchase its stock from former ESOP participants and their beneficiaries. The savings association should perform a careful analysis of the magnitude of the obligation and include it in the financial planning process if necessary to ensure that enough cash is available.

Accounting

The present accounting for ESOPs comes from a project undertaken by the Accounting Standards Executive Committee (AcSEC), which resulted in Statement of Position 93-6 (SOP 93-6, Employers' Accounting for Employee Stock Ownership Plans). This SOP provides guidance on employers' accounting for ESOPs. The SOP applies to all employers with ESOPs (both leveraged and nonleveraged). It does not address reporting by ESOPs. There is a discussion of financial reporting by ESOPs in the AICPA Audit and Accounting Guide: Audits of Employee Benefit Plans.

The necessity for SOP 93-6 is due to the great expansion in the number of ESOPs, their increased complexity, plus revised laws by Congress concerning ESOPs. In addition, the Internal Revenue Service (IRS) and the U.S. Department of Labor (DOL) issued many regulations covering the operation of plans. These actions caused changes in the way ESOPs operate and the reasons for their establishment.

SOP 93-6 brought significant changes in the way employers report transactions with leveraged ESOPs. Although SOP 93-6 did not change how employers with nonleveraged ESOPs account for ESOP transactions, it contains guidance for nonleveraged ESOPs.

The following paragraphs summarize significant accounting rules applicable to employer's accounting for ESOPs.

Leveraged ESOPs

- Employers should report the issuance of new shares or the sale of treasury shares to the ESOP when the issuance or sale occurs. Also, employers should report a corresponding charge to unearned ESOP shares, a contra-equity account.

- For ESOP shares committed for release in a period to compensate employees directly, employers should recognize compensation cost equal to the fair value of the shares committed for release.

- For ESOP shares committed for release in a period to settle or fund liabilities for other employee benefits, employers should report satisfaction of the liabilities when the employer commits to release the shares to settle the liabilities. Other employee benefits include an employer's match of employees' 401(k) contributions or an employer's obligation under a formula profit-sharing plan. The use of an ESOP has no bearing on the recognition of compensation cost and liabilities associated with providing such benefits to employees.

- For ESOP shares committed for release to replace dividends on allocated shares used for debt service, employers should report satisfaction of the liability to pay dividends when the ESOP commits for the release of shares for that purpose.

- Employers should credit unearned ESOP shares as they commit shares for release based on the cost of the shares to the ESOP. Employers should charge or credit to additional paid-in capital the difference between the fair value of the shares committed for release and the cost of those shares to the ESOP.

- Employers should report dividends on unallocated shares as a reduction of debt or accrued interest payable or as compensation cost. The use of the dividend for either debt service or payment to participants determines the form of accounting entry. Employers should charge dividends on allocated shares to retained earnings. They should make satisfaction of dividends payable by one of the following:

  — Contributing cash to the participant accounts.

  — Contributing additional shares to participant accounts.

  — Releasing shares from the ESOP's suspense account to participant accounts.

- Employers should report redemptions of ESOP shares as purchases of treasury stock. Employers should also report redemption of shares of leveraged and nonleveraged ESOPs as purchases of treasury stock. Employers must give a put option to participants holding ESOP shares that are not readily tradable. When participants exercise a put option, employers must repurchase the shares at fair value. The put option requirement applies to both leveraged and nonleveraged ESOPs.

- Employers that sponsor an ESOP with a *direct loan* (a loan made by a lender other than the employer to the ESOP) should report the obligations of the ESOP to the outside lender as liabilities. Employers should accrue interest cost on the debt. They should report cash payments made to the ESOP to service debt as reductions of debt and accrued interest payable when the ESOP makes payments to the outside lender. Apply this rule regardless of whether the source of cash is employer contributions or dividends.

- Employers that sponsor an ESOP with an *indirect loan* (loan made by the employer to the ESOP with a related outside loan to the employer) should report the outside loan as a liability. Employers should not report a loan receivable from the ESOP as an asset and should not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Employers do not recognize in the financial statements contributions to the ESOP or the concurrent payments from the ESOP to the employer for debt service.

- Employers that sponsor an ESOP with an *employer loan* (no related outside loan) should not report the ESOP's note payable and the employer's note receivable in the employer's balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.

- For earnings per share computations, consider ESOP shares committed for release as outstanding. ESOP shares are not outstanding if there is no commitment for release.

Nonleveraged ESOPs

- Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan. Measure compensation cost as the fair value of shares contributed to or committed for contribution to the ESOP as appropriate under the terms of the plan.

- Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to retained earnings. An exception is that employers should account for suspense account shares of a pension reversion ESOP in the manner described in SOP 93-6 for leveraged ESOPs.

- Account for the redemption of shares of a nonleveraged ESOP in the same manner as that required for a leveraged ESOP. Employers must give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires employers to repurchase the shares at fair value. The put option requirement applies to both leveraged and nonleveraged ESOPs. Employers should report the satisfaction of such option exercises as purchases of treasury stock. (See the prior discussion of redemptions in the leveraged ESOPs section.)

- Treat all shares held by a nonleveraged ESOP as outstanding in computing the employer's earnings per share, except suspense shares of a pension reversion ESOP. Treat shares of a pension reversion ESOP as outstanding until making commitment for release for allocation to participant accounts. Different rules also apply if a nonleveraged ESOP holds convertible preferred stock.

Consult SOP 93-6 for a comprehensive discussion of rules applicable to employers' accounting for ESOPs.

REFERENCES

United States Code (12 USC)

Federal Reserve System

§371c(23A)	Banking Affiliates
§371c-1(23B)	Restrictions on Transactions with Affiliates
Part 223	Transactions between Bank Member Banks and Their Affiliates (Regulation W)

Home Owners' Loan Act

§1464(i)	Conversions
§1464(o)	Conversion of State Savings Banks
§1464(p)	Conversions
§1467a(10)	Regulation of Holding Companies
§1468(11)	Transactions with Affiliates

Federal Deposit Insurance Act

§1817(j)	Change in Control of Depository Institutions

United States Code (15 USC)

Securities Exchange Act of 1934

§12	Registration Requirements
§13	Periodical and Other Reports
§14	Proxies
§16	Insiders

United States Code (29 USC)

§1001	Employee Retirement Income Security Act of 1974

Code of Federal Regulations (12 CFR)

FDIC Rules

Part 303 Subpart E	Change in Bank Control

Office of Thrift Supervision Rules

Part 543	Federal Mutual Associations
Part 552	Federal Stock Associations
§561.4	Affiliate
§561.5	Affiliated Person

§563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§563.43	Loans to Executive Officers, Directors and Principal Shareholders
§563.47	Pension Plans
§563.81	Issuance of Subordinated Debt Securities and Mandatorily Redeemable Preferred Stock
Part 563 Subpart E	Capital Distributions
§563.181	Reports of Change in Control of Mutual Savings Associations
§563.183	Reports of Change in CEO or Director
Part 563b	Conversions from Mutual to Stock Form
Part 563c	Accounting Requirements
Part 563d	Securities of Savings Associations
Part 563g	Securities Offerings
§565.4	Capital Measures and Capital Category Definitions
§567.5	Components of Capital
§567.13	Obligations of Acquirors of Savings Associations to Maintain Capital
Part 569	Proxies
Part 574	Acquisition of Control of Savings Associations
§584.1	Registration, Examination, and Reports

Code of Federal Regulations (17 CFR)

Securities and Exchange Commission Rules

§240.10b-5	Insider Trading
§240.12b	Registration under the Exchange Act
§240.13	Shareholder and Periodic Reporting
§240.14a	Proxies

§240.14c	Distribution of Information
§240.14e	Tender Offer Rules
§240.16a-1	Reports by Insiders
§240.17f-2	Fingerprinting of Transfer Agent Personnel
§240.17Ad-2	Turnaround of Items by Transfer Agents
§240.17Ad-4	Exempt Transfer Agents
§240.17Ad-11	Reports of Record Differences

OTS Applications Processing Handbook

Section 440	Stock Conversions

OTS Trust & Asset Management Handbook

Section 620	Employee Benefit Accounts

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 47	Disclosure of Long-term Obligations
No. 89	Financial Reporting and Changing Prices

Internal Revenue Service

Revenue Ruling 59-60 Stock Valuation

American Institute of Certified Public Accountants (AICPA) Statement of Position

No. 93-6	Employers' Accounting for Employee Stock Ownership Plans

Capital Stock and Ownership Program

EXAMINATION OBJECTIVES

Identify and determine the nature of ownership and control of the savings association.

Determine whether any individual has exerted a detrimental influence through ownership or control.

Determine if adequate physical safeguards for stock certificates and ownership records are in place.

Determine compliance with applicable laws, rulings, regulations, and any expressed agreements with OTS, FDIC, or state regulators.

Determine the adequacy of the savings association's policies, procedures, and controls related to capital stock.

Review securities filings for information of a supervisory interest and report results of the review to Business Transactions Division (BTD).

Determine if a savings association prudently administers an Employee Stock Ownership Plan (ESOP).

Initiate corrective action when deficiencies exist that could affect safety and soundness, or when you note significant violations of laws or regulations other than securities violations.

EXAMINATION PROCEDURES

LEVEL I

WKP. REF.

1. Determine through discussions with management and other appropriate verification methods, if management has taken corrective action relative to:

   - Prior examination report comments and prior examination exceptions.
   - Internal and external audit exceptions.
   - Any enforcement/supervisory actions and directives.

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2. Summarize information from securities offering filings, directors' minutes, audit reports, and other sources pertaining to any new issuance of capital stock (including the payment of stock dividends), notes, subordinated debentures, and other capital instruments. File the information within the continuing examination file (CEF), if applicable.

3. Either you or the regional office should make a brief review of the Forms 10-K, 10-Q, 10-KSB, 10-QSB and any other Exchange Act reports. (See Appendix A.) Compare the Exchange Act reports to TFRs, other reports, information, and documents relating to the savings association that are available. Immediately report any material discrepancies between the disclosures contained in the Exchange Act reports and information known to the regional office. The regional office should inform BTD and the Accounting Policy Division (APD) by e-mail.

4. Carefully review all transactions involving Treasury stock. Determine whether the board of directors' actions adequately supports Treasury stock transactions. Consider whether transactions have a detrimental effect.

5. Update the CEF, if applicable, with the Schedule of Stockholders (PERK 014). Alternatively, summarize the following information for each director and director's interests, officer, attorney, partner, and all other stockholders who own or control five percent or more of the savings association's stock:

- Number of shares.
- Percent to total outstanding.
- Stock certificate number (optional).
- Issuing price (optional).
- Date of issue (optional).

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- Confirm the timely reporting of changes in ownership on Forms 3, 4, 5 or Schedules 13D or 13G by companies subject to the Exchange Act.

6. Determine stock concentration by noting the total number of shareholders along with the number of shares outstanding.

7. If the savings association elected S Corporation status since the last examination, perform the following procedures:

   - Review the association's eligibility for the election.
   - Review shareholder agreements regarding stock transfers which management will use to maintain compliance with the eligibility requirements.
   - Verify that management has a method for monitoring ongoing compliance with S Corporation eligibility requirements.
   - Confirm that management periodically test and review the method for monitoring compliance.

8. Review whether the institution has realistic expectations about its ability to increase its capital while maintaining its S Corporation status.

9. Determine whether the association's management and shareholders understand that limitations may exist on the ability of an S Corporation to pay dividends.

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10. Determine whether management understands the overall effect of any potential dividend distribution limitations on an S Corporation.

11. Review proxy records from the last election of the directors. Identify anyone who has controlled the election of the board through proxies.

12. On the basis of information obtained in procedure No. 5 and review of shareholder and related information, consider:

    - Whether there was a change in control in the association. If yes, determine if BTD received the information for savings associations subject to the Exchange Act, and if not reported, provide details to BTD for a determination of needed disclosures.
    - Whether ownership, or change in control, of the savings association has significantly affected the savings association's operating policies or mode of operations to the detriment of the savings association.

13. ERISA and IRS rules and regulations are complex. Accordingly, you should request the ESOP administrator in the savings association to provide evidence that specialist legal counsel assists in helping to maintain the plan in compliance with all applicable rules and regulations. You should request the ESOP administrator to provide evidence that the savings association is able to meet its repurchase liability. The ESOP administrator also should support the stock valuation of closely held savings associations.

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14. From a review of plan documents or other appropriate sources, determine the duties and responsibilities of the savings association regarding its ESOP. Ascertain whether the savings association is satisfactorily performing its duties and responsibilities. If the need for expert advice is apparent, you should recommend that the savings association obtain the advice of an ESOP legal specialist. (*Note:* See the Trust & Asset Management Handbook for additional examination procedures if the savings association or its service corporation is acting as trustee, or serving in a fiduciary or similar capacity.)

15. If the savings association established an ESOP in conjunction with a conversion, determine if the ESOP purchased ten percent or more of the stock offered in the conversion.

16. Determine if the savings association aggregates stock held in the ESOP with an individual's purchase limitations. (They should not be aggregated.)

17. Determine if during a conversion the savings association extended its own credit to finance the funding of the ESOP. Also determine if during a conversion the savings association guaranteed the debt incurred by the ESOP when borrowing from another savings association.

18. Determine if the ESOP is an affiliate or an affiliated person. If so, verify that transactions such as loans and other financing arrangements with the savings association are consistent with OTS and FRB restrictions and prohibitions. (12 CFR §§ 561.5 and 563.43 and Federal Reserve Act §§ 23A and 23B.)

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19. Determine if an ESOP trust acquired control of the savings association or an S&L holding company outside of the conversion process. If so, verify OTS approval of the acquisition of control, as required by § 574.3.

20. Summarize pertinent information relating to stock option plans and ESOPs and file in the CEF, if applicable.

21. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

LEVEL II

1. Determine whether the association's management and shareholders understand that prohibitions exist on the ability of an association to make loans or discounts on the security of the shares of its own stock. Verify that the association is in compliance with these restrictions.

2. Ensure that capital distributions are of the type and in the amount permitted by Part 563, Subpart E – Capital Distributions.

3. For savings associations subject to the Exchange Act, determine whether the savings association makes timely required filings. If not, contact the regional office or BTD.

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4. If the savings association acts as its own transfer agent or registrar, examine the records pertaining to stock certificates to ensure controls are adequate to prevent over issuance of stock.

5. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, and recommendations for any necessary corrective measures, on appropriate work papers and report pages.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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WASHINGTON AND REGIONAL PROCESSING OF EXCHANGE ACT FILINGS

Background

Savings associations must provide full, fair, accurate and complete information regarding their business and financial condition to the investing public to avoid potential liability under the anti-fraud rules of the federal securities laws. It is essential to the supervisory efforts of the regional offices that regulators be aware of critical information disclosed in filings.

The Business Transactions Division (BTD) of the Office of Chief Counsel and the Accounting Policy Division (APD) of the Office of Supervision review Exchange Act and securities offering filings of savings associations for compliance with generally accepted accounting principles (GAAP), generally accepted auditing standards (GAAS), and with the Exchange Act and OTS regulations. Also, BTD, upon request, assists the SEC by reviewing filings of savings and loan holding companies referred by the SEC.

For purposes of this Appendix, we refer to BTD and APD as securities review staff when they perform dual functions. We refer to BTD and APD individually when they perform tasks independent of each other.

Coordination between regional and Washington staff is essential to ensure that savings associations fulfill their obligations to make full, fair, accurate, and complete representations to the public about their financial condition and operations. Reliable public disclosure and market integrity for saving association's securities are key to the savings association industry's capital-raising process.

General Procedures

The responsibility for reviewing disclosure documents filed by savings associations for compliance with the Exchange Act and the OTS securities offerings regulations rests with securities review staff. Securities review staff are responsible for issuing comment letters relating to a particular filing. Further, securities review staff are responsible for resolving legal, disclosure, and accounting questions that may arise under the Exchange Act and 12 CFR Parts 563b, 563d, and 563g. A specific attorney is assigned to each reporting savings association and reviews and examines all of that savings association's Exchange Act reports and any offering circulars it may file.

APD performs accounting reviews for the nontransactional Exchange Act filings and other filings and applications that contain financial statements. APD is primarily responsible for accounting reviews of the following forms: 8-K, 10, 10-SB, 10-K, 10-KSB, 10-Q, 10-QSB, 12b-25, applications for conversions, applications for conversions with mergers, and applications for mutual holding company conversions. The BTD staff is primarily responsible for accounting reviews for secondary offering circulars (of equity, debt and other securities) and mergers.

The regional office should contact securities review staff when questions arise with respect to a particular savings association's disclosure obligations. Also, the regional office should contact securities review staff by telephone or e-mail whenever information comes to their attention that potentially affects such reporting obligations.

Securities review staff closely review examination reports and other supervisory communications in connection with their review of securities filings to ensure appropriate disclosures in the filings. Staff works together to secure resolution of novel and precedential accounting issues.

APD generally issues accounting comments in conjunction with, but separate from, comments issued by BTD on the Exchange Act filings for which it has primary responsibility. Otherwise, BTD provides to the savings association or other filing party all comments relating to the accuracy, adequacy, and timeliness of Exchange Act filings made with OTS. Securities review staff and the regional office receives copies of all comments and responses regardless of which office issues the comments.

Securities review staff maintains a shared electronic file of all comments on filings that is accessible by each regional accountant or a designee. The shared file ensures that each office is aware of each other's findings and can determine if there is a need for a supervisory response. Securities review staff and the regional office must be aware of problems that require disclosure in filings. The regional regulator must be aware of securities review staff comments, and responses to those comments.

Securities review staff will resolve all issues regarding a savings association's compliance with issued comments. Also, BTD will resolve any necessary enforcement or other actions regarding compliance with filing requirements. In some instances, securities review staff may seek the assistance of a regional office in obtaining a savings association's compliance with comments. Securities review staff rely on regional regulators to observe and to report events that may affect Exchange Act disclosures, particularly events raising significant supervisory concerns. Regional regulators, therefore, must have a general knowledge of the content of a savings association's securities filings.

Time Requirements

For a report to be timely, OTS must receive a properly filed report by the required date. The mailing or post-marking of a report on the last day on which a report is to be filed does not constitute a timely filing.

A savings association may receive an extension of time to file a report if the savings association follows the procedures described in the regulations and satisfies all of the requirements of an extension. Exchange Act Rule (17 CFR § 240.12b-25) contains general provisions to follow if a savings association fails to file within a prescribed time frame all or portion of an Exchange Act periodic report. If a savings association fails to submit a complete Exchange Act periodic report within the prescribed time period, it must file a Form 12b-25. The savings association must file Form 12b-25 no later than one business day after the due date of such report. The association must disclose its inability to file the report on a timely basis and the reasons why in reasonable detail, and otherwise comply with all other requirements of Rule 12b-25. Among other things, the savings association must represent in the Form 12b-25 that it cannot eliminate the reasons for the delay without unreasonable effort or expense. The savings association also must represent that it will make the filing within the period of the extension. Rule 12b-25 provides for a 15-day extension for a Form 10-K or 10-KSB and a 5-day extension for a Form 10-Q or 10-QSB. Such extensions are available only upon an appropriate filing with BTD. Only one 15- or 5-day extension period, as appropriate for the type of filing, is available. No additional extensions of time are available under the regulations.

If appropriate, a savings association may represent that its failure to file a timely prescribed report is due to its inability to file the report without unreasonable effort or expense. Generally, late reports satisfy prescribed due dates only if the savings association meets all conditions of the rules.

When a savings association is unable to file a report on time, it should promptly consider its general public disclosure obligations. The savings association should determine whether it is appropriate to issue a press release to advise its stockholders and the public markets of material information pertaining to the savings association. In this regard, savings associations may wish to contact BTD or submit a written statement of the reasons for the delinquency. The statement should include a description of the steps the savings association is taking to come into compliance with the reporting requirements.

Regional Procedures

Securities oversight of savings associations is critically important. Regional regulators must alert the individual responsible for the particular savings association to all supervisory or other regulatory information that affects or may potentially affect securities law disclosure obligations. This reporting may be through e-mail. The use of e-mail provides more time for both the regional and securities review staff evaluation. Also e-mail facilitates the maintenance of the comments in a shared electronic file that is available to the regions and securities review staff.

Critical to an effective OTS oversight role is the certainty that regional personnel are thoroughly familiar with the current financial and operational condition of savings associations. Knowledgeable regional personnel should promptly review filings for supervisory concerns, and communicate any concerns to securities review staff. A critical component in securities review staff's Exchange Act oversight role is ensuring correction, as soon as possible, of any information in a public filing that is inaccurate, misleading, or incomplete. For this reason, regional regulators should promptly review Exchange Act filings, offering circulars, and applications for conversion.

The regional office should provide to securities review staff copies of all nonroutine correspondence to and from the savings association. Further, the regional office should provide copies of documents and internal memoranda that may contain information relevant to a savings association's disclosure obligations. Securities review staff examine this information to ensure that savings associations promptly comply with all disclosure obligations.

Achievement of successful supervision of savings association securities responsibilities requires uniformity and consistency of action. Regional personnel and BTD should coordinate a supervisory approach prior to initiating discussions with savings associations regarding requests for additional information or requiring corrective action under the Exchange Act. Should it become necessary, BTD will inform the Enforcement Division of Exchange Act or securities offering problems needing enforcement attention.

The regional office should determine if the savings association provides timely periodic Exchange Act filings. The regional office should maintain a schedule for each regional Exchange Act and 563g registered savings association indicating the due dates of all Exchange Act filings. This Handbook Section lists all common required filings and their respective time requirements. Regional offices should use this information to set up the schedules. Securities review staff maintain similar schedules and may assist the regional offices in setting up these schedules.

Savings associations must file required reports within prescribed time frames. Before the regional office contacts a savings association to inquire about a missing filing, they should first check with the assigned individual to determine if BTD has the filing. In certain instances a savings association may explain a late filing by filing Form 12b-25. Generally, this filing will allow a short extension of time to file certain reports. In addition, a savings association may inadvertently file reports with either BTD or the region, but not both. In such a case, BTD will direct the savings association to immediately file reports as required by the regulations, including Parts 563d and 563g.

Failure to file required reports on a timely basis may indicate deeper problems at a savings association. When regional regulators become aware of serious problems with a registrant savings association, they should immediately alert securities review staff by e-mail. Regional personnel should provide relevant supervisory information to securities review staff when practicable, rather than wait until completion of the next examination report.

Regional staff should quickly and promptly review all filings related to savings associations and holding companies to discover any information of supervisory interest. If regulators read the filings promptly, they may find serious problems disclosed in filings months before they would otherwise find them. A quick and timely review of filings may result in more timely initiation of a supervisory response that may require a restatement of earnings and financial position. In addition, the timely review of filings may lead to enforcement action, such as cease and desist, removal and prohibition, or receivership. Regional staff should not rely on securities review staff for this supervisory review. Further, regional staff should not duplicate the work of securities review staff in reviewing filings for compliance with the Exchange Act and Parts 563b, 563d, and 563g of the OTS regulations.

After a review of any filing, regional personnel should prepare a brief memorandum to securities review staff describing the review. The memorandum should disclose the existence of possible supervisory concerns and corrective actions that the regional office recommends. If the regional office notes problems, the filing will receive higher review priority. In the absence of such disclosure of potential concerns, the filing will likely receive a lower review priority. If necessary, securities review staff will prepare and issue a comment letter to the savings association concerning the disclosure problems. The regional office should promptly provide this memorandum via e-mail to securities review staff who will include the information in the shared electronic file.

When a savings association files an offering circular pursuant to Part 563g, BTD generally issues an initial comment letter on the filing within 14 to 30 calendar days of the filing date. This comment letter will generally include comments from the individual assigned to the savings association. Accordingly, regional staff should review offering circulars and provide any relevant information via e-mail to BTD within ten calendar days of filing. Satisfying this time frame will allow BTD to consider such information within the initial review period.

Regional regulators should be aware of significant events that have occurred requiring the filing of a current report on Form 8-K. The regional regulators should determine if the filing is timely. Consult with BTD if there is a question regarding the necessity of making a filing.

Filers must properly file and receive BTD clearance of proxy soliciting materials (or information statements, when applicable) before distribution to stockholders. Regional regulators should note these required steps. In addition, while not necessary, regional regulators may review proxy materials. If they do review proxy material, they should notify security review staff immediately by e-mail if they believe any proxy materials contain a material misstatement or omit any material information.

Regional regulators should be alert to changes in the majority of a savings association's board of directors resulting from actions other than a meeting of the stockholders. Regional regulators should promptly consult with BTD if questions arise regarding a change in the majority of a board of directors. Also, regional regulators should immediately notify BTD if problems arise.

Regional regulators should identify any savings associations with assets of more than $5 million that have 300 or more shareholders and a class of stock not registered under the Exchange Act. Also, regional regulators should identify formerly registered savings associations. Interpretive questions sometimes arise as to the meaning of "held of record" or "class" and regional regulators should refer these questions to BTD. If it appears that a savings association should have registered its stock under the Exchange Act, the regional office should advise securities review staff. The trigger for this inquiry is 300 shareholders because:

- Although 500 shareholders triggers registration under the Exchange Act, the number of shareholders may have increased to 500 or more since the last verification.

- Three hundred shareholders triggers deregistration.

Regional regulators should notify a savings association's officers, directors and significant shareholders of their responsibilities to file reports (with BTD in Washington and with the regional office) relating to their ownership of the savings association's securities. Savings association officers, directors and five percent or greater shareholders have ownership and transaction reporting requirements under the Exchange Act. The Exchange Act requires this information on Forms 3, 4, or 5 and Schedule 13D or 13G. The rules in this area can be extremely complex and there is a large body of judicial precedent dealing with this area. Refer questions regarding interpretation to BTD. Regional regulators should encourage those with obligations to file such reports to consult with their own counsel regarding their filing responsibilities.

Regional personnel should refer all comments or discovery of material information regarding savings and loan holding companies that are subject to Exchange Act filing requirements to BTD. Securities review staff will assess the materiality of the information for purposes of securities law obligations and will work with the regional personnel in deciding an appropriate response under the circumstances. Securities review staff will assess the information to determine whether a referral to the SEC is appropriate.

Regional office personnel are responsible for contacting holding companies that are not filing Form H-(b)11 as required. The inclusion of SEC filings in Form H-(b)11 does not mean that OTS necessarily has a role in performing disclosure review of those documents. Regional regulators should provide any comments to BTD for all securities filings that the holding companies provide and send BTD related correspondence and examination reports upon request.

Regional office personnel should also advise APD of any significant accounting disclosure problems and accounting issues noted during their review of Forms H-b(11) for holding companies that have thrift subsidiaries that file Securities Exchange Act filings with the SEC and/or the OTS.

You should report information concerning accounting or reporting problems that may affect the Thrift Financial Report (TFR) to the Financial Reporting Division (FRD), Dallas, TX. The staff of the FRD in Washington, DC can answer questions and provide advice concerning the correct completion of TFRs. Institutions should correct TFRs that are less than five months old in accordance with FRD's guidance.

Capital Adequacy

Capital absorbs losses, promotes public confidence, and provides protection to depositors and the FDIC insurance funds. It provides a financial cushion that can allow a thrift to continue operating during periods of losses or other adverse conditions. This Handbook Section provides guidance in determining a thrift's capital adequacy.

Capital Adequacy

A thrift's level of capital is adequate when it meets regulatory requirements, *and* is commensurate with the thrift's risk profile. The capital level should also be sufficient to support future growth. While minimum regulatory capital requirements provide a consistent starting point for determining capital adequacy, most thrifts should, and in fact do, exceed well capitalized standards (see Prompt Corrective Action (PCA) Categories below).

LINKS
Program
Appendix A
Appendix B
Appendix C

The various OTS capital requirements assume that a thrift primarily engages in traditional, relatively low risk activities. Higher risk permitted activities require more capital, especially if the activities are conducted at significant concentration levels. Lenders engaged in higher risk activities should also have higher Allowances for Loan and Lease Losses (ALLL) and risk management expertise appropriate to the risk.

OTS maintains, revises, and interprets its capital regulations in collaboration with the other federal banking agencies. OTS capital rules are substantively similar to those of the other banking regulators as a result of various statutory requirements. Federal statute requires that OTS capital regulations may be no less stringent than the capital regulations of the Office of the Comptroller of the Currency (OCC). In addition, the federal banking agencies must work together on an interagency basis to develop uniform rules implementing common statutory or supervisory policies, including capital requirements. Many of the agencies' uniform capital rules are based on the principles set out in an international agreement known as the Basel Accord.

You should review recent proposed and final regulations for the most current regulatory guidelines. You may also check with your OTS regional accountant or access guidance on the OTS Internet (www.ots.treas.gov). In addition, Schedule CCR (Consolidated Capital Requirement) of the Thrift Financial Report (TFR) Instruction Manual contains specific accounting and reporting instructions related to capital. OTS also posts on its website a series of Questions and Answers that help further clarify the reporting instructions. You should note however that the TFR instructions, as well as the Questions and Answers are to help inform and provide for a meaningful reporting function. They are generalized and abbreviated for readability. Ultimately the regulations (and statutes) have the controlling force of law.

SECTION OVERVIEW

This Handbook Section provides guidance in three main areas:

- Capital Requirements.
- Evaluating Capital Adequacy.
- Rating the Capital Factor.

Appendices to this Handbook Section provide additional guidance:

- Capital Components & Risk-Based Capital (Appendix A).
- Supplementary Information and Issues (Appendix B).
- Prompt Corrective Action (PCA) Restrictions (Appendix C).

CAPITAL REQUIREMENTS

Thrifts must meet two overlapping sets of capital rules required by different federal statutes. Thrifts must meet tangible, core, and risk-based standards required by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). In addition, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established Prompt Corrective Action capital categories.

Tangible, Core, and Risk-based Capital

The FIRREA-based requirements for tangible, core, and risk-based capital are defined in 12 CFR §567. OTS requires thrifts to satisfy three capital levels as follows:

Type of Capital	Percentage of Assets
Tangible Capital	1.5% of adjusted total assets
Leverage Ratio	4% of adjusted total assets (3% for thrifts with a composite CAMELS rating of 1)
Risk-Based Capital	8% of risk-weighted assets

Notes: We also refer to the leverage ratio requirement as the Tier 1 or core requirement. Adjusted total assets are defined in 12 CFR § 567.1. It is based on TFR assets adjusted for investment in subsidiaries, gains and losses on available-for-sale securities, certain hedges, and other adjustments.

Composition of Capital

A thrift's total (risk-based) capital is the sum of its Tier 1 (core) capital and Tier 2 (supplementary) capital, less certain deductions (see Appendix A). Note that Tier 2 capital may not exceed Tier 1 capital.

Appendix A summarizes the composition of Tier 1 and Tier 2 capital, and provides an explanation of the risk-based capital calculation.

Tangible Capital

Schedule CCR of the TFR includes detailed computational instructions for calculating core and risk-based capital. The TFR instructions do not include a calculation for tangible capital. While all three capital requirements exist as a matter of law, the tangible capital requirement has effectively been eclipsed by the more stringent PCA requirements (see below). Tangible capital is defined in 12 CFR § 567.9.

Prompt Corrective Action (PCA) Categories

You may find these FDICIA-based capital measurements in 12 CFR §565.

Thrifts fall into one of five PCA categories. The PCA minimum requirements are as follows:

	Tier 1/Leverage		Tier 1/Risk-Based		Total Risk-Based
Well Capitalized	5% or greater	*and*	6% or greater	*and*	10% or greater
Adequately Capitalized	4% or greater (3% for 1-rated)	*and*	4% or greater	*and*	8% or greater
Undercapitalized	Less than 4% (except for 1-rated)	*or*	Less than 4%	*or*	Less than 8%
Significantly Undercapitalized	Less than 3%	*or*	Less than 3%	*or*	Less than 6%
Critically Undercapitalized	Has a ratio of tangible equity* to total assets that is equal to or less than 2%				

* The definition of tangible equity under PCA differs from the definition of tangible capital under FIRREA. You may find the definition of tangible equity in 12 CFR § 565.2(f).

Minimum Standards vs. Capital Adequacy

The regulatory capital requirements are minimum standards designed for soundly managed thrifts that do not present credit or other risks requiring more capital. *Compliance with the minimum capital requirements does not automatically ensure an adequate level of capital. Thrifts with higher risk should hold capital well in excess of the minimum requirements, and in fact, well in excess of the FDICIA well capitalized standards.* In addition, OTS has the authority to establish a capital requirement for a thrift that is higher than its normal minimum regulatory capital requirement.

Capital For Subprime Lending Programs

Thrifts with subprime lending programs are responsible for quantifying the amount of capital they need to offset the additional risk for these programs. As a starting point you should reasonably expect a thrift to hold capital against subprime portfolios in an amount that is one and one half to three times greater than for nonsubprime assets of a similar type. A thrift's ALLL should also be adequate to address its subprime program. More information about subprime lending and risk analysis for capital adequacy is available in guidance issued by the four federal banking agencies and available on the OTS website. It applies to subprime lending programs that exceed 25 percent of a thrift's Tier 1 capital. (Refer to CEO Memo No. 137, Expanded Guidance for Subprime Lending Programs, issued February 2, 2001.)

Individual Minimum Capital Requirement (IMCR)

OTS may impose an IMCR in accordance with 12 CFR § 567.3. The regulation includes an extensive (but not all-inclusive) list of the reasons that may support imposition of an IMCR. There are no formal policies or procedures governing the IMCR process, but OTS would generally take the following steps:

- Determine that a thrift should have capital above the minimum regulatory standard.
- Notify the thrift of the determination and provide a general explanation.
- Provide an opportunity for the thrift to respond (generally within 30 days, but OTS may shorten this timeframe if circumstances warrant).
- Consider the thrift's response.
- Determine the appropriate minimum capital level for the thrift.

Whenever you find capital to be insufficient relative to a thrift's risk profile, you should discuss with your regional management the appropriateness of an IMCR.

Reservation of Authority

OTS may use its reservation of authority to target a higher capital level for specific assets or conditions, or to eliminate or limit the inclusion of a capital component, or to otherwise achieve a higher capital level. Through the reservation of authority, OTS may require the discounting or deduction of an asset or capital component, or may assign a higher risk weight or conversion factor than an asset or risk exposure normally receives. Refer to 12 CFR § 567.11. Whenever you find that a capital instrument, an asset, or a portfolio of assets does not provide meaningful capital support (and where the asset classification process does not address the problem), you should discuss the use of the reservation of authority with your regional management.

Documentation Requirements

Thrifts must have adequate systems in place to compute their capital requirements and capital levels. Supporting documentation should establish how a thrift tracks and reports its capital components, how it risk weights its assets, and how it calculates each of its capital levels. Where a thrift has inadequate documentation to support its assignment of a risk weight to a given item, examiners may assign an appropriate risk weight to that item. Examiners should verify that thrifts are correctly reporting the information requested in Section CCR of the Thrift Financial Report that is used in computing the capital requirements.

EVALUATING CAPITAL ADEQUACY

In order to determine whether a thrift has sufficient capital at a specific point in time, you should first consider whether the thrift complies with the following requirements:

- Regulatory capital requirements.
- Capital levels established by a business plan or the Board of Directors.
- Capital levels established by a capital plan, approved application, IMCR, enforcement action, other applicable agreement or plan, or through use of the OTS reservation of authority.

You should then determine if the thrift holds capital that is sufficient relative to its risk profile. This process evolves during your examination. You should consider all of the following factors, as well as any other important factors that you note.

Asset Quality

Asset quality is a key factor in evaluating capital adequacy. You should consider the extent to which individual assets exhibit serious weaknesses or loss of value. Key indicators of overall asset quality are the dollar value of assets subject to adverse classification and the severity of those classifications relative to capital. You should consider delinquency and foreclosure trends, the level of nonaccrual or nonperforming loans, and market depreciation of securities. When assessing capital adequacy, you should evaluate the risks associated with each lending and investment program. Thrifts with higher risk lending programs should maintain sufficient ALLL to offset expected losses and a higher capital base to absorb unanticipated losses.

Earnings

Consider earnings performance and dividend practices. Good earnings performance enables a thrift to fund its growth and remain competitive in the marketplace while at the same time retaining sufficient equity to maintain a strong capital position. However, excessive dividends can negate even exceptional earnings performance and result in a weakened capital position. Generally, management should first apply earnings to the elimination of losses and the establishment of necessary reserves and prudent capital levels; and then, after full consideration of those needs, management may disburse dividends in a reasonable amount.

Subordinate Organizations

Subordinate organizations can significantly affect the operations and overall financial condition of their parent thrift. Therefore, it is important to determine if subordinate organizations pose risk to the capital adequacy of the parent. Where a regulator other than OTS regulates the subordinate organization, it is important to consider whether capital from the subordinate organization would actually be available to the parent thrift in a time of stress. Furthermore, it is important to consider whether the parent thrift has obligated itself, either formally or informally, to fund obligations of its subsidiary. As with other assets, OTS examiners may classify as substandard, doubtful or loss, a thrift's investment in its subordinate organizations including loans to subordinate organizations. In some instances, OTS requires deduction (and deconsolidation where applicable) of a parent's investment in its subordinate organization. (See Appendix B for further details.)

Relationships with Affiliates

A holding company's policies and practices can significantly affect the capital levels of its thrift subsidiary. It is critical that a thrift's dividend policies, tax-sharing agreements, consulting arrangements, and other transactions with its holding company do not lead to an unsafe or unsound condition for the thrift.

Double-leveraging occurs when a thrift's parent organization borrows funds to purchase newly issued stock of the subsidiary thrift. If the principal means of servicing the parent company's debt consists of the cash dividends from the thrift, you should consider the potential effect on earnings. In particular, you should ascertain whether the thrift has the ability to sustain an adequate level of capital given the cash dividend demands of the parent holding company.

When you evaluate capital adequacy, you should generally discount the thrift's capital level by the amount of any loans or other credits or investments outstanding to the thrift's holding company or to affiliates that are not subordinate organizations of the thrift.

Interest Rate Risk

Thrifts with excessive interest rate risk exposure may experience a significant decline in capital levels as a result of unfavorable changes in interest rates. Therefore thrifts with relatively high interest rate risk should have correspondingly high capital levels to offset that risk.

Liquidity and Funds Management

Thrifts that are in a constricted liquidity situation may have no alternative but to dispose of assets at a loss in order to honor funds outflows, and such losses must be absorbed by the capital accounts. Generally, the lower a thrift's level of liquidity, the more seriously you should consider higher capital requirements.

Deposit Structure

You may analyze capital in light of the historical and projected rate of growth of the thrift's deposit accounts. If a thrift is located in a strongly developing market where earnings retention is unable to keep pace with deposit growth, management should take all reasonable steps to augment the capital accounts, or find other means to maintain capital ratios. In addition to growth trends, the presence of volatile deposit accounts or concentrations in the deposit structure is also relevant. The greater the instability of the deposit base, the greater the need for a strong level of capital.

Contingent Liabilities

Lawsuits involving the thrift as defendant or other contingent liabilities may indicate a need for a greater level of capital protection. You should determine whether the thrift has significant contingent liabilities that have the potential to materially impact the capital level.

Off-Balance-Sheet Activities and Exposures

A thrift may engage in off-balance-sheet activities such as trust administration, mortgage banking, or construction lending. In such cases, you must determine whether the thrift is exposed to economic risks or potential legal liabilities that are not fully captured by generally accepted accounting principles (GAAP) or regulatory capital rules. Note that while risk-based assets include many off-balance-sheet risk exposures, the Tier 1 capital requirement does not address off-balance-sheet risk.

New Products and Activities

The financial marketplace is dynamic and innovative. Many thrifts constantly formulate new products and engage in new activities to meet customers' needs. You should determine whether a thrift has properly analyzed the risks related to new products and activities, and whether capital levels are appropriate to match these risks.

Local Characteristics

The stability and diversification of local population, business, industry or agriculture are important considerations. In evaluating capital adequacy, you should consider potential changes in the thrift's operating environment as well as the pressures of competition.

Risk Diversification

Generally, a greater degree of asset and liability concentrations increases the need for capital at most thrifts. You should review on- and off-balance-sheet assets for concentrations in industries, product lines, customer types, geographic areas, funding sources, and nontraditional activities.

Quality of Management

The ability, experience, depth, integrity and record of management are important in your assessment of a thrift's capital adequacy. In fact, it is difficult to conceive of a capital structure capable of withstanding the deterioration that eventually results from inept or dishonest management. Sound management includes the formulation and implementation of strong policies and procedures relative to loans, investments, interest rate risk, operations, internal controls, audits, and other functional areas. Deficiencies in these policies or their implementation can readily have an adverse effect on the thrift's capital position.

Future Plans

Consider reasonable expectations of what may occur in the future. It is not sufficient to simply consider that capital is adequate as of the examination date. Conditions on which you base that judgment can change materially. You should consider the thrift's business plan or capital plan and its underlying assumptions. Such a review is largely a reasonableness check of the forecasted numbers and their underlying assumptions. Specifically you should consider the following:

- Whether the plans are consistent with the trend of historical performance.
- The volume of nonaccrual and renegotiated debt and other nonearning or marginally earning assets.
- Loan demand.
- Deposit growth.
- Competition.
- General composition and strength of the local economy.
- Expansion plans.
- Other pertinent factors.

An analysis of the ratio of equity growth to asset growth can be helpful in your analysis of capital trends. When this ratio is less than one, it signifies that assets are expanding faster than capital growth, hence a declining equity position and increasing financial leverage.

Peer Comparison

You should also assess capital adequacy by comparing a thrift with similar (peer) institutions, though you should not rely on this information exclusively. For example, while strong management practices or stringent internal controls may reduce the need for additional capital in some cases, weak management practices or controls may indicate a need for higher capital elsewhere. You should make an independent, case-specific judgment on the capital adequacy for each thrift you examine.

RATING THE CAPITAL COMPONENT

This determination is a judgmental process that requires you to consider all of the objective and subjective variables, concepts and guidelines discussed above. You should evaluate capital relative to a thrift's risk profile, rather than simply to a minimum regulatory requirement. These are the standards set by the Uniform Financial Institutions Rating System:

- A rating of "1" indicates a strong capital level relative to the thrift's risk profile.
- A rating of "2" indicates a satisfactory capital level relative to the thrift's risk profile.
- A rating of "3" indicates a less than satisfactory level of capital that does not fully support the thrift's risk profile. The rating indicates a need for improvement, even if the thrift's capital level exceeds minimum regulatory and statutory requirements.
- A rating of "4" indicates a deficient level of capital. In light of the thrift's risk profile, viability of the thrift may be threatened. The thrift may need assistance from shareholders or other external sources of financial support.
- A rating of "5" indicates a critically deficient level of capital that threatens the thrift's viability. The thrift needs immediate assistance from shareholders or other external sources of financial support.

REFERENCES

United States Code (12 USC)

§ 1464(s)	Minimum Capital Requirements
§ 1464(t)	Capital Standards
§ 1831o	Prompt Corrective Action

Code of Federal Regulations (12 CFR)

§ 563.74	Mutual Capital Certificates
§ 563.81	Issuance of Subordinated Debt Securities and Mandatorily Redeemable Preferred Stock
Part 565	Prompt Corrective Action

Part 567	Capital

Office of Thrift Supervision Bulletins and CEO Letters

Regulatory and Thrift Bulletins

RB 18	Enforcement Series
RB 33a	FDIC "Pass-Through" Deposit Insurance Coverage Disclosure Rule
TB 56	Regulatory Reporting of Net Deferred Tax Assets

CEO Letters

No. 135	The New Basel Capital Accord
No. 137	Expanded Guidance for Subprime Lending Programs
No. 141	Joint Agency Advisory on Brokered and Rate-Sensitive Deposits
No. 160	Regulatory Capital Treatment for Accrued Interest Receivable in Credit Card Securitizations
No. 161	Unsafe and Unsound Use of Covenants Tied to Supervisory Actions in Securitization Documents
No. 162	Implicit Recourse in Asset Securitizations
No. 163	Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations

Additional Interagency Guidance

Interim Regulatory Reporting and Capital Guidance on FAS 133, "Accounting for Derivative Instruments and Hedging Activities," 12/29/1998

Capital Adequacy Program

EXAMINATION OBJECTIVES

To determine the adequacy and composition of the thrift's current and planned level of capitalization, considering the thrift's unique risk characteristics, overall condition, and planned direction.

To determine the effectiveness of management and the board of directors in actively monitoring, maintaining, and planning for capital adequacy.

To determine if the thrift's capital-related policies and procedures are adequate and are being adhered to by thrift personnel.

To determine the adequacy of audit and accounting practices and procedures, including the system of internal controls, as they relate to capital accounts.

To determine compliance with laws, rulings, regulations, and specific agreements with OTS, FDIC, or state authorities.

To ascertain the need for, or to initiate, corrective action (including acting under prompt corrective action provisions) when policies, practices, procedures, or internal controls are deficient, or when there are violations of laws, rulings, directives, or regulations.

EXAMINATION PROCEDURES — WKP. REF.

LEVEL I

1. Obtain and review the information on capital provided in the UTPR, off-site monitoring reports, report of examination spreadsheets, latest examination report, latest audit reports, latest SEC reports, business plan, and correspondence with the OTS and other regulatory authorities. Consult with the examiner(s) reviewing the board of directors and committee minutes for any other items pertinent to the review of capital.

2. Through discussions with management and review of documents, determine if management has taken corrective action relative to:

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

WKP. REF.

- Prior examination report comments and exceptions.
- Internal and external audit exceptions.
- Any enforcement/supervisory actions and directives.

3. Review the thrift's compliance with relevant capital standards.

   - Compare capital levels with minimum PCA capital requirements, and determine the institution's PCA capital category.
   - Is the institution subject to any capital plan, capital directive, supervisory action, written agreement, or application condition regarding capitalization? If so, is the institution in compliance?
   - Is the institution in compliance with its internal business plan or board imposed capital targets?
   - Evaluate the thrift's risk profile including asset composition, interest rate risk, and other risks including off-balance-sheet risk.

4. Review trends in capital levels and ratios. Consider the prospects for continuing capital compliance, and consider whether management has planned for capital adequacy in line with anticipated growth. Consider whether the risk orientation of the institution is changing.

5. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

WKP. REF.

LEVEL II

1. Verify the reliability and accuracy of the institution's capital calculations. If necessary, revise the capital calculations and recheck the PCA level.

- Identify and reconcile capital accounts for activity since the last examination. Verify the accuracy of entries and outstanding balances. Be alert for changes in the capital accounts that the thrift has not recorded in the income statement.
- Identify and investigate any material differences between capital reported to OTS in the TFR, and capital reported in the audited financial statements and SEC filings (as applicable).
- Obtain the latest quarter-end TFR Schedule CCR including the institution's corresponding worksheet for calculating its capital levels. Obtain related work papers and review them for reliability. Refer to the TFR instructions, Schedule CCR, for additional guidance.
- Consult with the examiner completing Program 410, Financial Records and Reports, to determine if there are any reporting errors that could affect the institution's capital requirement calculations.
- Verify that the institution's capital calculations are accurate. Some of the following areas may be material to the reliability of the capital calculations:

  — Subsidiary activities

    ✓ Are the activities permissible?

    ✓ Has the institution properly excluded or deducted its nonincludable subsidiaries?

    ✓ Have loans and advances to impermissible subsidiaries been deducted from capital and assets as required?

  — Has the thrift deducted goodwill and intangible assets from capital and assets?

  — Are assets subject to limitation appropriately handled?

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- ✓ Servicing assets
- ✓ Purchased credit card relationships
- ✓ Deferred tax assets
- ✓ Credit enhancing IO strips

— Are unrealized gains and losses on AFS securities properly handled?

— Are maturing capital instruments properly handled?

— Is the ALLL free of specific reserves?

— Has the thrift institution properly excluded from risk-based capital items that are not includable (for example, equity investments, reciprocal holdings of capital instruments)?

— Are delinquent single-family and multi-family loans properly risk weighted?

— Are high LTV loans properly risk weighted?

— Are LIP and commitments properly handled?

— Are post-period-end adjustments correct?

— Has the thrift properly treated assets sold with recourse?

— Is the thrift properly holding dollar-for-dollar capital against most residual interests? (And, is the thrift deducting any credit-enhancing interest-only strips that exceed 25 percent of Tier 1 capital?)

2. Determine a level of capital that is appropriate for the risk profile. Where applicable, apply the capital guidance for subprime lending programs. If appropriate, recommend an individual minimum capital requirement, or use of the OTS reservation of authority.

- Consider the risk orientation and diversification of loan and investment portfolios. Do portfolios present excessive risk? Is the institution's risk orientation changing?

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- Identify and analyze the risks associated with off-balance-sheet activities. Analyze the economic risks or legal liability associated with activities such as asset securitization, trust administration, mortgage banking, or construction lending.
- Consider the institution's growth trends and goals. Review the effect of earnings and dividends on capital. Does the institution have the quality and level of earnings or balance sheet flexibility to support planned growth, structural changes, or new activities?
- Confer with the examiners assigned to Program 260, Classification of Assets, and Program 261, Valuation Allowances, to determine if specific allowances and ALLL are adequate. If not, determine the effect on capital. Ascertain the effect of current and potential losses.
- Consider whether asset portfolios have a higher than normal risk level for the particular type of asset. Protection against unanticipated or unidentified credit losses should be reflected in the institution's capital position. If an institution has a relatively high risk profile, its capital level should be commensurately higher.
- Evaluate capital adequacy of the thrift insitution after deducting assets of regulated subsidiaries and the capital needed to meet regulatory capital requirements at those subsidiaries.
- Consider the effect that service corporation and other subsidiary activities may have on the need for capitalization, including the potential liability of the parent thrift for obligations of the subsidiary.
- Evaluate the parent holding company's reliance on dividend payments from the subsidiary institution. Review related SEC filings for transactions between the institution and the holding company. Consider the appropriateness of earnings retention and dividend policies.
- Review the most recent external audit report (including management and internal control letter) and consult with the examiners assigned to Internal Controls and Internal Audit. Determine if deficiencies in internal controls and audit systems exist. Does an above normal level of operational risk require a higher level of capital?

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3. Assess management's capital planning process.

- Review management reports, such as the budget, strategic business plan, and capital plan to assess the adequacy and effectiveness of the institution's planning efforts.
- Evaluate the institution's access to capital markets. Consider the probability of success of planned capital-raising strategies.

4. If capital falls below the PCA well capitalized standards or if you determine that capital is inadequate or marginal relative to the institution's risk profile:

- Identify the appropriate PCA category. Discuss your determination with the EIC and OTS regional management.
- Determine if a supervisory or enforcement action is appropriate to address the capital deficiency or whether an IMCR Directive should be imposed. Discuss your recommendation with the EIC and OTS regional management. See Appendix A, Prompt Corrective Action Guidelines in Section 370, Enforcement Actions, for guidance.
- Confirm with your regional office that they are following PCA guidelines.
- Review any Guarantee of Controlling Parties for adequacy.
- Identify the need for any additional operating restrictions.
- Inform management of your conclusions, and the restrictions that apply to an institution that is less than well capitalized. The following restrictions apply:
  - — The mandatory and discretionary supervisory actions that apply to an institution that is less than adequately capitalized (Number 5 below).
  - — The pass-through insurance restrictions (Number 6 below).
  - — The broker deposit restrictions (Number 7 below).

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5. If the institution is less than adequately capitalized (as reflected in its TFR report, a final report of examination, or disclosed in a notice from OTS – see §565.3), you should review for compliance with the mandatory and discretionary supervisory actions. You can refer to §565.6 for a description of the mandatory and discretionary actions.

6. If the thrift institution is less than well capitalized, or if based upon your examination findings, you believe it may become less than well capitalized in the near future, review for notification of account holders subject to losing FDIC pass-through insurance coverage (see Regulatory Bulletin 33a):

- Determine whether the thrift has any employee benefit plan deposits or intends to accept any employee benefit plan deposits.
- If so, review the procedures developed to ensure compliance with FDIC regs at 12 CFR §330.14. This would include:
  - — A determination that sample disclosures have been developed and shared with appropriate thrift personnel.
  - — A determination that procedures have been developed to provide the appropriate disclosures to employee benefit plan depositors when opening a new account and when an existing empoyee benefit plan depositor (administrator or manager) makes a request for information.

7. Check for compliance with brokered deposit restrictions. Only well capitalized institutions may accept brokered deposits without restriction. If the thrift institution is not well capitalized, you may refer to Examination Handbook Section 560, Deposits and Borrowed Funds, for the applicable restrictions and prohibitions on brokered deposits.

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8. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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CAPITAL COMPONENTS & RISK-BASED CAPITAL

This appendix is an abbreviated summary from the Capital Regulation. Refer to the regulation in 12 CFR §567 for important details and other items not included in this appendix. You will find relevant definitions in §567.1. We have organized this Appendix as follows:

- Composition of Capital.
- Risk-based Capital.
- Risk-based Capital Treatment for Recourse Exposures, Direct Credit Substitutes, and Residual Interests.

COMPOSITION OF CAPITAL

Tier 1 (Core) Capital

Tier 1 (core) capital includes:

- GAAP capital.

Less

- Investments in and advances to nonincludable subsidiaries.
- Goodwill and other intangible assets.
- Equity instruments not qualifying for Tier 1 capital[1] (for example, cumulative preferred stock).
- Servicing assets and purchased credit card relationships (PCCRs) in excess of limitations (see §567.12).
- Disallowed deferred tax assets (see Thrift Bulletin No. 56).
- Credit-enhancing interest-only strips in excess of 25 percent of Tier 1 capital (see §567.5 and §567.12).
- Accumulated gains on certain available-for-sale debt and equity securities[1] and qualifying cash-flow hedges.[2]

[1] Refer to the TFR instructions. The purpose is to exclude certain components of GAAP capital that are not part of common stockholders' equity under regulatory capital definitions.

[2] Refer to the December 1998 interagency statement, "Interim Guidance on the Regulatory Reporting and Capital Treatment of Derivatives."

Plus

- Minority interests in equity accounts of fully consolidated includable subsidiaries.
- Mutual thrift nonwithdrawable and pledged deposit accounts.
- Accumulated losses on certain available-for-sale debt securities,[1] and accumulated losses on qualifying cash-flow hedges.[2]

Tier 2 (Supplementary) Capital

Tier 2 (supplementary) capital includes:

- Permanent capital instruments such as:
  - Mutual capital certificates and nonwithdrawable accounts not counted for Tier 1 capital.
  - Cumulative perpetual preferred stock.
  - Qualifying subordinated debt.
- Maturing capital instruments (for example, non-perpetual preferred stock).
- Allowance for loan and lease losses (ALLL) up to 1.25 percent of risk-weighted assets.
- Up to 45 percent of unrealized gains, net of unrealized losses on available-for-sale equity securities with readily determinable fair values.

Note: Tier 2 capital may not exceed Tier 1 capital.

Total (Risk-based) Capital

A thrift's total (risk-based) capital is the sum of:

- Tier 1 capital.

Plus

- Tier 2 capital (to the extent that Tier 2 capital does not exceed 100 percent of Tier 1 capital).

Less

- Reciprocal holdings of the capital instruments of another depository institution.
- Equity investments (using the definition of equity investments in §567.1).
- Low-level recourse exposures and residual interests that the thrift chooses to deduct using the simplified/direct deduction method excluding:

— The credit-enhancing interest-only strips already deducted from Tier 1 capital. (See low-level recourse and residual examples further below.)

RISK-BASED CAPITAL

General Description

The risk-based capital requirement captures primarily credit risk from on-balance-sheet assets and most off-balance-sheet commitments and obligations. OTS requires a thrift to maintain a total risk-based capital ratio equal to at least 8 percent of assets after risk weighting. Most thrifts have a risk-based capital ratio of 10 percent or higher in order to manage a well capitalized status.

You determine a thrift's risk-weighted assets by allotting assets among the risk-weight categories. There are four standard risk-weight categories: 0 percent, 20 percent, 50 percent, and 100 percent.[3] The risk weight depends upon the nature of the assets, obligors, and collateral. In general, if a particular item can be placed in more than one risk category, you may assign it to the category that has the lower risk weight. However, the following procedures apply:

- You convert off-balance-sheet commitments and exposures to credit equivalent amounts by a conversion factor. You then risk weight the credit equivalent amounts in accordance with the rules used for on-balance-sheet assets.
- Many recourse exposures and direct credit substitutes generally require a gross-up capital treatment.
- Most residual interests receive a dollar-for-dollar capital treatment.

Assuming the PCA category of adequately capitalized, the effect of this risk weighting approach is the following:

Risk Weight Bucket	Effective Capital Charge
0%	No capital charge
20%	1.6%
50%	4.0%
100%	8.0%
200%	16.0%
Dollar-for dollar	100.0%

[3] There is also a 200% risk weight-category used in the ratings-based approach. In addition, certain items receive a dollar-for-dollar capital treatment, equivalent to a risk weighting of 1250% (the reciprocal of 8%). See the Recourse section later in this Appendix.

Risk Weights: On-Balance-Sheet Assets

Asset types not specifically addressed in the regulation automatically receive a 100 percent risk weight unless OTS determines that a different risk weight, or a different capital treatment is appropriate. Below is a general summary of the risk weight buckets:

0 Percent Risk-Weight Category

This category is for the lowest risk assets. This category includes:

- Cash.
- Obligations of, or fully guaranteed by, the full faith and credit of the United States Government (includes most GNMA obligations).
- Balances at Federal Reserve Banks.

20 Percent Risk-Weight Category

This category is for very high credit-quality assets. The 20 percent risk-weight category includes:

- Securities issued by or guaranteed by government sponsored agencies (including Fannie and Freddie for example), *except for their principal only securities (POs), interest-only securities (IOs)*, and their equity securities.
- Claims on, balances due from, and stock of the Federal Home Loan Banks.
- Items collateralized by cash held in a segregated deposit account at the thrift.
- The portion of assets collateralized by the current market value of U.S. Government securities.
- Assets conditionally guaranteed by the U.S. Government or its agencies.
- General obligations of state and local governments.
- Claims on domestic depository institutions.
- Asset-backed securities rated AAA or AA under the ratings-based approach, but excluding stripped securities.
- Certain claims on, or guaranteed by, qualifying securities firms.

  A *qualifying securities firm* in the United States is a broker-dealer registered with the Securities and Exchange Commission (SEC) that complies with the SEC's net capital regulations. A different definition applies to foreign-based firms. (See § 567.1.)

  For a claim on, or guaranteed by, a qualifying securities firm to qualify for 20 percent risk weight, the firm must have a long-term issuer credit rating, or a rating on at least one issue of long-term unsecured debt, from a nationally recognized statistical rating organization (NRSRO). The rating must be in one of the three highest investment grade categories used by the NRSRO. If two or more NRSROs assign ratings to the firm, the thrift must use the lowest rating to determine whether it meets the rating requirement. The firm may rely on the rating of its parent consolidated company *if the parent guarantees the claim*.

A collateralized claim on a qualifying securities firm does not have to comply with the rating requirement if it meets all of the following requirements:

— It is a reverse repurchase/repurchase agreement or securities lending/borrowing transaction executed using standard industry documentation.

— It is collateralized by debt or equity securities that are liquid and readily marketable.

— It is marked to market daily.

— It is subject to a daily margin maintenance requirement under the standard industry documentation.

— It can be liquidated, terminated or accelerated immediately in bankruptcy or similar proceeding, and the security or collateral agreement will not be stayed or voided under applicable law.

50 Percent Risk-Weight Category

This risk-weight category is for high credit quality assets. The 50 percent risk-weight category includes:

- Qualifying mortgage loans.
- Qualifying multifamily mortgage loans.
- Qualifying residential construction loans.
- Privately issued securities (excluding stripped or subordinated securities) backed by qualifying one- to four- family or multifamily mortgage loans – where the underlying loans are eligible for 50 percent risk weight.
- Most state and local revenue bonds.
- Asset-backed securities rated “A” under the ratings-based approach, but excluding stripped securities.

Qualifying mortgage loans are residential first mortgage loans on houses, condominiums, cooperative units, and manufactured homes. You do not include boats, motor homes, and time-share properties, even if they are a primary residence. Loans must not be over 90 days past due. You include mortgage loans on mixed-use properties that are primarily one- to four-family if they meet the qualifying criteria.

If a thrift holds the first and junior lien(s) on a property, and no other party holds an intervening lien, you treat the transaction as a single loan secured by a first lien. Refer to 12 CFR §567.1 for the definition of qualifying mortgage loans. Note that the definition refers to and incorporates loan to value (LTV) criteria from the real estate lending guidelines in §560.101. Loans above 90 percent LTV will not typically qualify for 50 percent risk weight unless they have acceptable private mortgage insurance or other appropriate credit enhancement to effectively reduce their LTV to 90 percent or less.

Qualifying multifamily mortgage loans must meet the specific criteria of the regulation that tracks a federal statute. (Refer to the definition in 12 CFR §567.1.)

Qualifying residential construction loans must meet the specific criteria of the regulation. (Refer to 12 CFR §567.1.)

100 Percent Risk-Weight Category

This is the standard risk-weight category. You place assets not assigned another risk weighting in this category (excluding assets deducted from capital and residual interests which have a dollar-for-dollar capital requirement). You include the following in the 100 percent risk-weight category:

- Commercial loans and commercial real estate loans.
- Consumer loans.
- Second mortgage and home equity loans (except where you combine them with a qualifying first mortgage – see qualifying mortgage loan explanation above).
- Single-family and multifamily housing loans that do not qualify for the 50 percent risk-weight category.
- Construction loans.
- Mortgage-backed securities not qualifying for a lower risk-weight category, including most stripped securities (POs and IOs) issued by government sponsored agencies (but excluding subordinated classes, and excluding securities backed by subprime assets).
- Corporate debt securities.
- Bonds issued by a state or local government where a private party is responsible for payment.
- Repossessed assets and loans 90 days past due.
- Asset-backed securities rated “BBB” under the ratings-based approach, but excluding stripped securities.

Ownership in Mutual Funds (and other pooled assets)

For investments in investment companies, such as mutual funds, there are two alternatives:

- You may assign the entire investment to the risk-weight category applicable to the riskiest asset held in the investment company portfolio.
- You may assign different risk weights to the fund on a pro-rata basis, according to the investment limits for the different investment categories in the fund's prospectus.

The lowest risk weight for a mutual fund is 20 percent.

Off-Balance-Sheet Risk Exposures

Credit Conversion Factors for Off-Balance-Sheet Items

You determine risk weights for most off-balance-sheet items in a two-step process. First, you multiply the face amount of the item by a credit conversion factor to get the balance sheet credit equivalent amount. You then risk weight the credit equivalent amount based on the nature of the collateral, the obligor, or type of asset.

Example: Conversion of an off-balance-sheet item

The thrift has extended a $30,000 home equity line of credit with a multi-year term. The borrower has not yet drawn the $30,000 and the line of credit remains unfunded. As shown in the bulleted list below, the conversion factor for home equity lines of credit for terms over one year is 50 percent. Assume that the line qualifies for 50 percent risk weight under the definition of qualifying mortgage loan (that is, where it may be combined with the first mortgage and there is no intervening lien – explained above in the 50 percent risk weight section).

- You multiply the unfunded line by the 50 percent conversion factor: $30,000 x 50% = $15,000.
- You then risk weight the $15,000 that you calculated. $15,000 x 50% risk weight = a $7,500 risk-weighted asset.
- You multiply the risk-weighted asset x the 8% risk-based capital requirement. $7,500 x 8% = $600.

As a result, the thrift must hold $600 in capital for the unfunded $30,000 line.

Note: For recourse exposures, direct credit substitutes, and subordinate exposures (other than residual interests), you generally must first gross-up the entire group of assets or total exposure that the off-balance-sheet item supports.

There are four credit conversion factor groups: 0 percent, 20 percent, 50 percent, and 100 percent.

0 Percent Credit Conversion Factor Group

This group includes:

- The unused portion of unconditionally cancelable retail credit card lines.
- Unused commitments (including LIP) with an original maturity of one year or less. (*This applies to most commitments to originate 1-4 family loans*).

LIP and other unused commitments with an original maturity over one year *if* they are unconditionally cancelable at any time at the thrift's option *and* the thrift either: (1) makes a separate credit decision before honoring each draw, or (2) at least annually performs a credit review to determine whether or not the lending facility will continue.

20 Percent Credit Conversion Factor Group

This group is for a narrow set of trade-related contingencies. That is, short-term, self-liquidating instruments used to finance the movement of goods and collateralized by the underlying shipment. A commercial letter of credit is an example of such an instrument.

50 Percent Credit Conversion Factor Group

This group includes:

- Unused portions of commitments, including home equity lines of credit, with an original maturity exceeding one year.
- Most LIP commitments with an original maturity over one year.
- Transaction-related contingencies such as performance bonds and performance-based standby letters of credit related to a particular transaction. For example, arrangements backing subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

100 Percent Credit Conversion Factor Group

This group includes:

- Guarantees or financial guarantee-type standby letters of credit.
- Recourse arrangements.
- Forward agreements with a certain drawdown. For example, legally binding agreements to purchase assets at a specified future date.
- Risk participations purchased in bankers acceptances.

Interest-Rate and Foreign Exchange-Rate Contracts

The credit equivalent amount of an interest-rate or exchange-rate contract is the sum of the current credit exposure (that is, the replacement cost of the contract) and the potential future credit exposure of the contract. You calculate this as follows:

<u>Begin with</u>: Replacement value of the contract, that is, the fair value of the contract, but not less than zero.

<u>Add</u>: Potential future credit exposure. To obtain potential future credit exposure you multiply the notional principal amount of the contract by the appropriate credit conversion factor. You can find the conversion factors from the chart:

Remaining Maturity	Interest rate contracts	Foreign exchange rate contracts
One year or less	0.0%	1.0%
Over one year	0.5%	5.0%

Then: Once you determine the credit equivalent amount, you assign it to the risk-weight category appropriate to the counterparty, or, if relevant, to the nature of any collateral or guarantee. However, the maximum risk weight is 50 percent.

Note: There are certain exceptions to the above calculation for foreign exchange contracts with an original maturity of less than 14 days, and for interest rate and exchange rate contracts traded on an exchange requiring the daily payment of variations in the market value of the contract. Thrifts may use bilateral netting to compute the net replacement value for multiple contracts with the *same* counterparty under certain conditions specified in the regulation.

Risk-Based Capital Treatment for Recourse, Direct Credit Substitutes, and Residual Interests

On November 29, 2001, OTS and the other federal banking agencies issued a capital rule for recourse, direct credit substitutes, and residual interests in asset securitizations. The capital rule addresses many aspects of risk resulting from asset securitization. While it integrates some aspects of OTS's previously existing capital rules and guidance for recourse and direct credit substitutes, the rule is far more extensive in order to address a very complex, evolving securitization marketplace. This section outlines and highlights some aspects of the rule that should be of interest to many thrifts. However, because of the complex nature of the rule, we recommend that you refer to the rule itself and its extensive preamble published in the federal register, which are available through the OTS web site at: *www.ots.treas.gov/docs/73135.pdf.*

You can find the definitions pertaining to the rule along with other terms used in the OTS capital regulations in 12 CFR §567.1. The capital treatment from the rule is in §567.6(b). Refer also to CEO Letter No. 162, "Implicit Recourse in Asset Securitizations," and to CEO Letter No. 163, "Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations." OTS issued these CEO letters on May 23, 2002. They provide important supplementary information.

Through the rule's reservation of authority, OTS looks to the substance of a transaction regardless of how others categorize the allocation of risk. OTS may find that the proposed capital treatment by the thrift does not appropriately reflect risk to the thrift. OTS may then require the thrift to apply another risk weight, conversion factor, or treatment that OTS deems appropriate.

This part contains three sections:

- Capital Treatment for Recourse and Direct Credit Substitutes.
- Capital Treatment for Residual Interests.

- The Ratings-based Approach.

Capital Treatment for Recourse and Direct Credit Substitutes

Recourse

The term recourse refers to a thrift's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold. A recourse obligation typically arises when a thrift transfers an asset in a sale (a sale according to generally accepted accounting principles) and retains an obligation to repurchase the asset or to otherwise absorb losses on the asset. Examples of recourse obligations include:

- Assets sold under an agreement to repurchase.
- Credit-enhancing representations and warranties related to sold assets.
- Retained loan servicing with an agreement under which the thrift is responsible for losses associated with the loans serviced (except for servicer cash advances as defined in §567.1).
- Clean-up calls on assets sold (except for clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the thrift).
- Credit derivatives that absorb more than the thrift's pro rata share of losses on transferred assets.
- Loan strips sold where the maturity of the transferred portion of the loan is shorter than the commitment under which the loan is drawn.

Recourse can also exist implicitly. Implicit recourse arises when a thrift repurchases assets, absorbs losses, or otherwise supports assets that it has sold, in instances where it is *not contractually required* to do so. Refer also to CEO Letter No. 162.

As with other off-balance-sheet exposures, you must convert a recourse exposure to an on-balance-sheet asset by obtaining a credit equivalent amount. In the case of a simple loan sale with recourse, which may or may not involve asset securitization, you convert the entire balance of the loans sold to an on-balance-sheet asset using the 100 percent conversion factor.

In many instances a thrift retains a recourse exposure that is limited in dollar amount or as a percentage of assets transferred, but is designed to absorb the first losses that occur for the entire pool of transferred assets. The recourse exposure thus absorbs *more than its pro rata share of losses*. As a result, the general capital treatment for recourse exposures is gross-up*,* whereby the thrift must hold capital for the full amount of the transferred assets as if they were still on the balance sheet. OTS applies this relatively rigorous capital treatment because the recourse exposure receives more than its pro rata share of risk; it has the concentrated risk of all of the assets senior to it in the pool.

Therefore using the required gross-up approach, you obtain the credit equivalent amount by multiplying the *full amount of the credit-enhanced assets* for which the thrift directly or indirectly retains or assumes credit risk by a *100 percent conversion factor*. You assign this credit equivalent amount to the risk-weight category appropriate to the obligor in the underlying transaction after considering any associated guarantees or collateral. However, the following points apply:

- A thrift does not have to hold recourse capital for qualifying mortgage loans (50 percent risk weight 1-4 family loans) that it has sold, if the sales contract allows only a 120-day period for return of those loans. The thrift must have originated the loans within one year before sale. This exception would apply to a simple loan sale as well as a sale of loans into a securitization.

- There is an exception to the gross-up treatment for low-level recourse exposures where recourse is legally and contractually limited to an amount less than the on-balance-sheet capital requirement. OTS limits the capital requirement to the maximum exposure rather than the full ordinary capital requirement.

- A ratings-based approach allows a thrift to reduce its capital requirement for lower-risk, highly-rated recourse exposures.

Example: Recourse sale of loans

A thrift has sold $100 in qualifying mortgage loans (that is, 50 percent risk weight 1-4 family loans) into a securitization with an agreement to repurchase them for up to 180 days. Until the recourse period expires, total risk-weighted assets must include: ($100) x (100 percent conversion factor) x (50 percent r.w.) = $50. Thus, the capital requirement is: $50 x 8% = $4

Note: If the sales agreement limited the recourse to 120 days or less, there would be no capital requirement.

Example: Low-level recourse

A thrift contractually limits its maximum recourse exposure to less than the normal on-balance-sheet capital requirement for the assets sold with recourse. For example, if a thrift sells a $100,000 mortgage loan with 1 percent recourse, it is liable for $1,000 in losses, OTS requires the thrift to deduct $1,000 in computing the numerator for risk-based capital.

(This is in lieu of the thrift holding $4,000 in capital - assuming the loan qualifies for 50 percent risk weight).

The thrift may report this capital requirement in either of two ways: (1) a simplified/direct deduct approach where the thrift deducts the amount for computing total risk-based capital; or (2) a risk-weighted approach where the thrift multiplies the exposure by 12.5 (the reciprocal of 8%). In the risk-weighted method the thrift multiplies the $1,000 capital requirement by 12.5 for a risk-weighted asset of $12,500. Then, when the thrift multiplies $12,500 times the 8% risk-based capital requirement, the result is a $1,000 capital charge.

Direct Credit Substitutes

A thrift can guaranty, purchase, or assume a recourse exposure from another organization. We generally refer to these exposures as *direct credit substitutes*. A purchased subordinated security is an example of a direct credit substitute. Direct credit substitutes can be on- or off-balance-sheet. Examples of direct credit substitutes include:

- Financial standby letters of credit that support financial claims on a third party that exceed the thrift's pro rata share of the financial claim.

- Purchased subordinated interests that absorb more than their pro rata share of losses from the underlying assets.

When a thrift purchases a *subordinated asset-backed security* or similar interest, the thrift generally must gross-up the risk exposure in order to determine the capital requirement. This means that the thrift must hold capital against the total amount of the subordinated security plus all assets senior to it. However, the low-level recourse rule can apply to direct credit substitutes, and the ratings-based approach may also apply.

Example: Direct credit substitute – gross-up treatment

A thrift has purchased the first dollar loss subordinated interest of $5 in a securitization of $100 in qualifying mortgage loans (1-4 family 50% risk weight loans). The thrift must gross-up its exposure to include all exposures that are more senior to the security that the thrift owns. Thus the thrift must convert the $100 balance of the pool to an on-balance sheet asset at a 100% conversion factor. Then, the thrift risk weights the loans at 50%, resulting in $50 in risk-weighted assets. The capital requirement is $50 times 8 percent = $4.

Note: This example assumes that the first dollar loss position is **not** a credit-enhancing I/O strip (see Residual Interests below).

Capital Treatment for Residual Interests

Residual interests are on-balance-sheet risk exposures arising from sales (transfers) of financial assets that expose a thrift to credit risk on those transferred assets that exceeds a pro rata share of any claim that the thrift has on the assets. Residual interests do not include interests purchased from a third party, except for credit-enhancing interest-only strips. A primary example of a residual is a *retained* subordinated interest in assets formerly owned by the thrift.

The standard capital treatment for most residual interests is *dollar-for-dollar*. That is, the thrift must hold one dollar in capital for every one dollar in residual interests.

Example: Residual interests

A thrift has retained the first dollar loss subordinated interest of $15 in *its own securitization* of $100 in qualifying mortgage loans (50% risk weight 1-4 family). The risk-based capital requirement is $15, that is, $1 of capital for $1 of residual interests – dollar-for-dollar capital.

Similar to the low-level recourse example, the thrift may report this capital requirement in either of two ways:

- A simplified/direct deduct approach where the thrift deducts the amount for computing total risk-based capital.

- A risk-weighted approach where the thrift multiplies the exposure by 12.5 (the reciprocal of 8%).

In the risk-weighted method the thrift multiplies the $15 capital requirement by 12.5 for a risk-weighted asset of $187.5. Then, when the thrift multiplies $187.5 times the 8% risk-based capital requirement, the result is a $15 capital charge.

Credit-enhancing Interest-only Strips

Credit-enhancing interest-only strips (CE I/Os), whether retained or purchased, pose higher risk than most other residuals. If a thrift has a concentration of more than 25 percent of Tier 1 capital in CE I/Os, it must *deduct from Tier 1 capital*, the portion of CE I/Os that exceeds 25 percent of Tier 1 capital.

Example: Credit-enhancing I/O strip:

A thrift has the first dollar loss subordinated interest (whether retained or purchased) that is a credit-enhancing I/O strip, of $15 in a securitization of subprime auto loans. Tier 1 capital is $40 at onset. The thrift does not have any other CE I/Os.

- 25 percent of $40 is $10. $15 exceeds $10 by $5, so you deduct $5 in computing Tier 1 capital.
- Tier 1 capital is $35. ($40 - $5 = $35.)
- The thrift must also hold $10 in risk-based capital for this exposure because you deduct the same amount, $5, as above from the $15 I/O strip. The thrift must hold dollar-for-dollar risk-based capital against the remaining balance.

The Ratings-based Approach

The ratings-based approach allows for the possibility of a lower risk-based capital requirement (reflecting less risk) for certain recourse, direct credit substitutes, and residual interests arising from asset securitization. Ratings must be from one or more NRSROs, for example Standard & Poors, Moody's, and Fitch Ratings. Exceptions to the ratings-based approach include:

- Credit-enhancing I/O strips are *not* eligible for the ratings-based approach.
- Bonds not in security form are not eligible.
- Bonds not backed by assets are not eligible.

In general, the following schedule applies to long-term ratings:

Long-Term Rating Category	Examples	Risk Weight
Highest or second highest investment grade	AAA or AA	20%
Third highest investment grade	A	50%
Lowest investment grade	BBB	100%
One category below investment grade	BB	200%
More than one category below investment grade, or unrated	B or unrated	Not eligible for ratings-based approach.

Note: There is also a separate short-term rating table. Refer to the regulation.

The ratings-based approach makes a distinction between "traded" and "nontraded" positions. Nontraded positions require:

- An external rating by more than one NRSRO.
- Minimum rating assigned by each NRSRO that meets all of the following:
  - — Long term: no worse than one category below investment grade.
  - — Short term: investment grade.
  - — Rating must be publicly available.
  - — Rating must be based on the same criteria as for traded positions.

Note: The capital regulations allow for use of a thrift's internal ratings in limited circumstances *after* initial and ongoing OTS approval. The thrift must use software and ratings that correspond credibly and reliably to the NRSRO ratings.

Program Ratings

A thrift can use *program ratings* for certain risk exposures in particular secondary market loan programs. A thrift may make use of program ratings *after* OTS has reviewed the nature of the program and accepts, under specific conditions, a rating assigned to a particular risk exposure that the thrift retains. The rating must correspond credibly and reliably with an NRSRO rating, for example AA.

SUPPLEMENTARY INFORMATION AND ISSUES

Allowance for Loan and Lease Losses (ALLL)

A valuation allowance is a contra-asset account, established and maintained through charges against current earnings to absorb losses in a thrift's portfolio. Valuation allowances established to absorb the losses inherent in a thrift's overall loan and lease portfolio are the Allowance for Loan and Lease Losses, or ALLL. A thrift's ALLL is part of Tier 2 (supplementary) capital, up to 1.25 percent of risk-weighted assets. Thrift's may not use the ALLL to cover losses that are not credit-related or losses on other types of assets (that is, assets other than loans or leases). Valuation allowances established to absorb losses identified for specific assets are Specific Valuation Allowances, or SVAs. For capital purposes, the ALLL does not include SVAs. SVAs require a separate deduction from capital.

ALLL only covers *incurred credit-related losses* in the asset portfolio. Thrifts with higher risk activities should maintain higher capital levels to protect against unanticipated losses.

Impact of Subordinate Organizations on Capital Requirements[1]

OTS capital regulations classify a subordinate organization as either a *subsidiary* or an *investment*. Generally, subsidiaries are entities in which the parent thrift has a majority ownership interest. The regulations also distinguish whether or not a subsidiary is an *includable subsidiary*. An includable subsidiary engages only in activities that are permissible for a national bank.[2] Note that a thrift's operating subsidiary is typically an includable subsidiary. The capital treatment for a subordinate organization depends on its status as follows:

Capital Treatment for Subordinate Organizations Having Another Regulator

This section applies to most functionally regulated subsidiaries[3] as well as most subsidiary depository institutions that have a primary regulator other than OTS. In analyzing the capital of a thrift that owns these subordinate organizations, OTS deducts capital needed to meet the requirements of the primary regulator[4]. Then, OTS makes a determination as to whether the excess capital in the subsidiary (that is, capital in excess of the stated formal requirements of the subsidiary's primary regulator) is available to the entities above it in the organizational hierarchy. In these situations, OTS will review the examination reports of the subsidiary's primary regulator (and engage in discussions with the

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1 Refer to the definitions of includable subsidiary and equity investment in 12 CFR §567.1, the requirement for deduction of nonincludable subsidiaries in §567.5(a), the preapproved activities for service corporations in §559.4, and the list of activities permissible for a national bank available on the website of the Office of Comptroller of the Currency at: www.occ.treas.gov.

2 This refers to the activities of a national bank itself, not to the activities permissible for a national bank's subsidiary.

3 Functionally regulated subsidiaries include: registered broker-dealers, registered investment advisors, registered investment companies, insurance companies, or entities subject to regulation by the Commodity Futures Trading Commission.

4 A small number of thrifts have established subsidiaries to reinsure first mortgage residential loans originated by the thrift and insured with private mortgage insurance (PMI). These subsidiaries are consolidated onto the thrift's balance sheet for regulatory capital; however, the PMI reinsurance risk assumed by the subsidiary will count as part of the parent thrift's exposure on the loan for risk-based capital purposes; and where the thrift sells a loan with PMI retained, the loan is then treated as sold with recourse for risk-based capital purposes. A thrift can avoid these additional requirements on PMI reinsurance by deconsolidating and deducting its investment in the PMI subsidiary, after review and concurrence by the OTS.

subsidiary's primary regulator) in order to determine whether the subsidiary's excess capital is transferable and available to support the parent. Depending upon the outcome of this analysis, OTS decides whether to permit inclusion of the subsidiary's excess capital.

Capital Treatment for Subsidiaries

Includable Subsidiaries

For GAAP and TFR reporting purposes, the thrift ordinarily consolidates the assets of its includable subsidiary into the parent. For Tier 1 capital, the subsidiary's assets comprise part of the parent's adjusted total assets on schedule CCR. For risk-based capital, the thrift risk weights the subsidiary's assets on schedule CCR along with its own.

Nonincludable Subsidiaries

When a GAAP-consolidated subsidiary is not includable for regulatory capital purposes, the thrift must deconsolidate the subsidiary's assets and liabilities, and deduct for Tier 1 capital its investment in that subsidiary.[5] The thrift makes the deduction on Schedule CCR according to the instructions and this does not affect Schedule SC or reporting under GAAP. This deconsolidation and deduction approach means that the subsidiary will be ignored for capital purposes: its assets not included with those of the thrift, and its capital not included in the thrift's capital base. The capital deduction will include the following:

- The parent's equity investment in the subsidiary.
- The parent's loans and other advances to the subsidiary.
- Where applicable, an amount representing any guarantees by the parent of the subsidiary's debt made on behalf of a third party.

Capital Treatment for Equity Investments

When a thrift does not have majority ownership of a subordinate organization, it generally does not consolidate the assets of the subordinate organization with the parent. Instead, the thrift uses the equity method to account for its investment in that subordinate organization. In the equity method, the thrift's investment in the subordinate organization is a thrift asset for GAAP and for Schedule SC. The capital treatment, however, will generally depend upon whether or not the subordinate organization engages solely in activities permissible for a national bank.

Includable Activities Only

The thrift's investment in the subordinate organization is a component of adjusted total assets for regulatory capital purposes. When computing the risk-based capital requirement on Schedule CCR, the thrift risk weights its investment in the subordinate organization at 100 percent. The thrift does not risk

[5] There is an exception to this automatic deduction treatment. Section 12 USC 1464(t)(5) exempts from automatic deduction those subsidiary depository institutions acquired before May 1, 1989, even though they may be engaged in activities not permissible for a national bank.

weight the subordinate organization's assets, only the parent's investment in the subordinate organization.

Nonincludable Activities

If the subordinate organization engages in activities that are nonincludable, the thrift should deduct its investment in the nonincludable activity for Tier 1 capital. The capital deduction will include the following:

- The parent's equity investment in the subsidiary.
- The parent's loans and other advances to the subsidiary.
- Where applicable, an amount representing any guarantees by the parent of the subsidiary's debt made on behalf of a third party.

The use of intermediate organizations, or the legal form of organization, will not affect the deduction.

Reservation of Authority

In some instances, OTS uses its reservation of authority to require (or permit) deduction, or deconsolidation *and* deduction, of a subordinate organization that would not otherwise be so treated. Where OTS uses its reservation of authority, a simple deduction from Tier 1 capital would apply to a subordinate organization reported under the equity method of accounting per GAAP; whereas, deconsolidation *and* deduction would apply to subsidiaries consolidated under GAAP.

You may consider whether to recommend to your regional office deduction of *investment in or loans to* a subordinate organization using the reservation of authority. In some instances, a thrift requests a deduction approach. OTS reviews the request and then decides whether to approve it.

Construction Loans

Construction loans receive a 100 percent risk weight unless they meet the definition of qualifying residential construction loans (below), or the definition of qualifying mortgage loans (that is, loans to individual borrowers for the construction of their own homes that meet the definition in §567.1).

Qualifying Residential Construction Loans

Qualifying residential construction loans, also referred to as residential bridge loans, have similar credit risk to single-family residential mortgage loans. Residential construction loans must meet specific criteria in order to qualify for a 50 percent risk weight. You may review the definition of qualifying residential construction loans in §567.1.

Loans-in-Process

Many thrifts initially record a construction loan as a debit entry to loans receivable equal to the gross amount of the loan. They in turn make a credit entry to a contra-asset account called, "loans in process of disbursement" (LIP). A thrift then reduces the LIP balance with each disbursement of funds.

Therefore, the LIP represents the undisbursed portion of the loan and is off-balance- sheet. For capital purposes, the thrift needs to convert the LIP to an on-balance-sheet credit equivalent amount as described below. If a thrift does not set up a loans-in-process account, the thrift should still treat the unfunded (undisbursed) loan commitment in the same manner as an off-balance-sheet item for capital purposes. LIP or other unfunded construction loan balances will either:

- Convert at 0 percent (that is, there is no capital requirement).
- Convert at 50 percent to an on-balance-sheet credit equivalent (that is, a risk-weighted asset).

If the original maturity of the construction loan is one year or less, LIP (or the unfunded construction commitment) should generally convert at 0 percent. When the original maturity of the loan exceeds one year, the LIP (or unfunded commitment) should generally convert at 50 percent, in which case the thrift then risk weights the credit equivalent amount based on the type of loan: for example, 50 percent for qualifying residential construction loans or qualifying mortgage loans, 100 percent for most other types of loans.

Notes:

- Thrifts should not split LIP (or the unfunded commitment) on a single loan into a component that matures within one year and a component that matures after one year.
- Thrifts may apply a 0 percent conversion factor to a loan with more than a one-year term if they actively evaluate the credit relationship and structure the terms of the loan to comply with §567.6(a)(2)(iv). Specifically the thrift must have a contractual right to separately underwrite each disbursement and the thrift does so, or the thrift has a contractual right to reevaluate the lending relationship at least annually and the thrift does so.

(See also Appendix A, the subsection titled Credit Conversion Factors for Off-Balance-Sheet Items.)

Nonwithdrawable (Pledged) Deposit Accounts of Mutual Institutions

Directors or officers of mutual savings associations, or other interested individuals or organizations, may pledge personal deposits held by the institution. These deposits can count as Tier 1 capital. The individuals must formally subordinate the deposits to the institution's creditors, including the FDIC. The deposits must satisfy the same criteria as noncumulative perpetual preferred stock. The pledge must affirm that the deposits have no maturity, allow no option for withdrawal of the funds, and allow the suspension of interest payment obligations. Sections 561.31, 567.5(a)(1)(iv), and 567.9(b)(3) describe how mutual institutions may use these accounts for regulatory capital purposes. Note that this form of regulatory capital is relatively uncommon.

Preferred Stock

General limitation on preferred stock: OTS has a general policy that the majority of a thrift's equity should be common voting shares. Preferred stock should not comprise the majority of a thrift's capital base.

REIT Preferred Stock

General limitation on REIT preferred stock: OTS generally limits REIT preferred stock to 25 percent of Tier 1 capital.

REIT (real estate investment trust) preferred stock is a hybrid instrument that combines traits of both debt and equity and offers special tax treatment. REIT preferred stock pays dividends like an equity investment, but is backed by collateral similar to certain debt instruments. Under certain conditions, REIT preferred stock may receive favorable capital treatment.

In a typical REIT preferred stock transaction, a thrift or holding company establishes a separate legal entity that owns 100 percent of the entity's common stock. In most cases, the value of the common stock is nominal. After establishing the new separate legal entity, the thrift sells real-estate-related assets, usually mortgages or mortgage-back securities, to this separate entity. The new entity pays for the real estate-related assets with cash proceeds from a simultaneous preferred stock issuance to independent third parties.

If the issuing entity is a subsidiary of the thrift, the subsidiary is fully consolidated with the thrift for TFR purposes. In the consolidated statements, the thrift reports the REIT preferred stock as minority interest in includable consolidated subsidiaries, a component of Tier 1 (core) capital.

The issuing entity can also be a subsidiary of a thrift's holding company. In these situations, some or all of the cash proceeds received by the holding company is down-streamed to the thrift. This generally represents an additional investment in the thrift and counts as Tier 1 capital.

The asset-backed nature of REIT preferred stock raises supervisory concerns, especially when the thrift issues the stock through a subsidiary of the thrift. If the thrift faces operating difficulties, *all* assets of the consolidated entity should be available for the thrift's use. Therefore, *OTS requires thrift subsidiaries to include certain restrictive covenants in REIT preferred stock offerings*. OTS requires that the stock be permanent (or perpetual) and noncumulative as to dividends. Additionally, OTS requires that the terms of the REIT preferred stock allow OTS to do both of the following:

- Restrict the payment of dividends on the REIT preferred stock.
- Require the conversion of the REIT preferred stock to common stock.

These restrictive covenants must be present for a thrift to include REIT preferred stock as Tier 1 capital.

Trust Preferred Securities

Trust preferred securities (TPS) are nonperpetual cumulative preferred stock issued by a wholly owned trust subsidiary of a corporation (typically insurance companies and bank or savings and loan holding companies). Cash raised through a trust preferred issuance by a thrift holding company can be down-streamed to the thrift institution. And then, at the thrift institution level, the cash received from the holding company can count as Tier 1 capital.

For more information and guidance on TPS refer to Thrift Bulletin 73a, Investing in Complex Securities.

Tier 2 Capital Instruments

Section 567.5(b) describes the components of Tier 2 capital, including *permanent capital instruments* and *maturing capital instruments*. These groups include certain types of debt instruments that are like capital in their capacity to absorb losses.

Permanent Capital Instruments

A thrift can generally include permanent capital instruments in its Tier 2 capital. Permanent capital instruments may include: cumulative and other perpetual preferred stock,[6] mutual capital certificates, perpetual subordinated debt, and mandatory convertible subordinated debt (capital notes). Refer to the regulation for qualifications and other instruments in this group.

Maturing Capital Instruments

Maturing capital instruments include:

- Subordinated debt (excluding perpetual subordinated debt – see above).
- Intermediate-term preferred stock and any related surplus (additional paid-in capital).
- Mandatory convertible subordinated debt (commitment notes).

Refer to the regulation for additional details. The degree to which a thrift can include these instruments in Tier 2 capital decreases according to the formulas and criteria described in §567.5(b)(3).

Thrifts that issue maturing capital instruments must choose between two options for regulatory capital treatment. Once a thrift selects an option, it must use that same option for all issuances outstanding at that time and for any subsequent issuances for as long as there is a balance outstanding. Once the thrift repays all outstanding issuances, it may elect a different option for future issuances.

Limits on Pass-Through Insurance Coverage

Normally, FDIC deposit insurance coverage ($100,000 per account) passes through financial intermediaries such as employee benefit plans to each beneficial owner (for example, to each employee participant in a plan). However if a thrift falls below PCA well capitalized status, the FDIC aggregates for deposit insurance purposes, any deposit that the thrift accepts (new, rolled-over, or renewed) through an employee benefit plan. The FDIC aggregates the deposits at the plan-administrator or

[6] A thrift may not include in capital preferred stock that is, in effect, collateralized by assets of the thrift or one of its subsidiaries, or issued by a nonincludable subsidiary.

fund-manager level, and then the deposits do not qualify individually for pass-through insurance.[7] The limitation affects the following types of employee benefit accounts and plans:

- 401(k) retirement accounts
- Deferred compensation plans
- Keough plan accounts
- Corporate pension plans
- Profit-sharing plan accounts

Simplified Employee Pension plan accounts (SEPs) are not subject to the limitation.

If a thrift falls below well capitalized status, it must notify affected account holders. Management should have procedures in place to monitor capital and notify affected parties. Additional information is in Regulatory Bulletin 33a, available on the OTS website. The relevant regulation section is §330.14, especially §330.14(h).

Net Deferred Tax Assets

OTS places limits on the inclusion of deferred tax assets in a thrift's Tier 1 capital. You may find OTS policy in Thrift Bulletin No. 56. To the extent that the realization of deferred tax assets depends on a thrift's future taxable income (exclusive of reversing temporary differences and carry-forwards), or its tax-planning strategies, deferred tax assets may not exceed the lesser of:

- The amount that the thrift can realize within one year of the quarter-end report date.
- Ten percent of Tier 1 (core) capital.

[7] This general rule applies unless: the institution is at least adequately capitalized, and has either obtained a brokered deposit waiver from the FDIC or provides specific notice to the plan depositor each time a deposit is accepted. Refer to RB 33a for more detail.

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Prompt Corrective Action Restrictions 12 CFR §565.6

Capital Category	*Restriction*
Well and adequately capitalized	Cannot pay dividends or management fees to controlling persons if it would result in undercapitalization.
Undercapitalized	**Mandatory actions:** • Capital distributions and management fees restricted. • Capital plan required. • Monitoring of condition and capital plan. • Growth restricted. • Prior approval of certain expansion proposals such as acquisitions, branching and new lines of business.
Significantly Undercapitalized	**Mandatory actions:** • Activities restricted. • Payments on subordinated debt restricted. **Discretionary actions:** • Require recapitalization: — Issue stock. — Require acquisition (if grounds exist for appointing a conservator or receiver). • Restrict interest rates paid. • Impose more stringent asset growth restrictions (or require shrinkage). • Restrict activities. • Improve management by requiring the election of directors or employment of qualified senior executive officers. • Prohibit deposits from correspondent banks. • Require prior approval for capital distributions by a bank holding company. • Require divestiture. • Require other actions the regulator determines appropriate.
Critically Undercapitalized	**Mandatory actions:** • Activities restricted - Associations may not: — Enter into any material transactions other than in the usual course of business. — Extend credit for any highly leveraged transaction. — Amend the association’s charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order. — Make any material change in accounting methods. — Engage in any covered transaction. — Pay excessive compensation or bonuses. • Payments on subordinated debt prohibited.

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